GOVERNMENT-SPONSORED HOUSING ENTERPRISES FINANCIAL SAFETY AND SOUNDNESS ACT OF 1991

HEARINGS

BEFORE THE

SUBCOMMITTEE ON

HOUSING AND COMMUNITY DEVELOPMENT

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HOUSE OF REPRESENTATIVES

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

ON

H.R. 2900

A BILL TO IMPROVE SUPERVISION AND REGULATION WITH RESPECT TO THE FINANCIAL SAFETY AND SOUNDNESS OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION, THE FEDERAL HOME LOAN MORTGAGE CORPORATION, AND THE FEDERAL HOME LOAN BANK SYSTEM, AND FOR OTHER PURPOSES

JULY 18 and 19, 1991

Printed for the use of the Committee on Banking, Finance and Urban Affairs

Serial No. 102-60

U.S. GOVERNMENT PRINTING OFFICE

45066

WASHINGTON : 1991

For sale by the U.S. Government Printing Office

Superintendent of Documents, Congressional Sales Office, Washington, DC 20402

ISBN 0-16-036997-5

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HENRY B. GONZALEZ, Texas, *Chairman*

FRANK ANNUNZIO, Illinois
STEPHEN L. NEAL, North Carolina
CARROLL HUBBARD, Jr., Kentucky
JOHN J. LaFALCE, New York
MARY ROSE OAKAR, Ohio
BRUCE F. VENTO, Minnesota
DOUG BARNARD, Jr., Georgia
CHARLES E. SCHUMER, New York
BARNEY FRANK, Massachusetts
BEN ERDREICH, Alabama
THOMAS R. CARPER, Delaware
ESTEBAN EDWARD TORRES, California
GERALD D. KLECZKA, Wisconsin
PAUL E. KANJORSKI, Pennsylvania
ELIZABETH J. PATTERSON, South Carolina
JOSEPH P. KENNEDY II, Massachusetts
FLOYD H. FLAKE, New York
KWEISI MFUME, Maryland
PETER HOAGLAND, Nebraska
RICHARD E. NEAL, Massachusetts
CHARLES J. LUKEN, Ohio
MAXINE WATERS, California
LARRY LaROCCO, Idaho
BILL ORTON, Utah
JIM BACCHUS, Florida
JAMES P. MORAN, Virginia
JOHN W. COX, Jr., Illinois
TED WEISS, New York
JIM SLATTERY, Kansas
GARY L. ACKERMAN, New York

CHALMERS P. WYLIE, Ohio
JIM LEACH, Iowa
BILL McCOLLUM, Florida
MARGE ROUKEMA, New Jersey
DOUG BEREUTER, Nebraska
THOMAS J. RIDGE, Pennsylvania
TOBY ROTH, Wisconsin
ALFRED A. (AL) McCANDLESS, California
RICHARD H. BAKER, Louisiana
CLIFF STEARNS, Florida
PAUL E. GILLMOR, Ohio
BILL PAXON, New York
JOHN J. DUNCAN, Jr., Tennessee
TOM CAMPBELL, California
MEL HANCOCK, Missouri
FRANK D. RIGGS, California
JIM NUSSLE, Iowa
RICHARD K. ARMEY, Texas
CRAIG THOMAS, Wyoming
SAM JOHNSON, Texas

BERNARD SANDERS, Vermont

Subcommittee on Housing and Community Development

HENRY B. GONZALEZ, Texas, *Chairman*

MARY ROSE OAKAR, Ohio
BRUCE F. VENTO, Minnesota
CHARLES E. SCHUMER, New York
BARNEY FRANK, Massachusetts
BEN ERDREICH, Alabama
THOMAS R. CARPER, Delaware
ESTEBAN EDWARD TORRES, California
GERALD D. KLECZKA, Wisconsin
PAUL E. KANJORSKI, Pennsylvania
STEPHEN L. NEAL, North Carolina
CARROLL HUBBARD, Jr., Kentucky
JOSEPH P. KENNEDY II, Massachusetts
FLOYD H. FLAKE, New York
KWEISI MFUME, Maryland
JOHN J. LaFALCE, New York
ELIZABETH J. PATTERSON, South Carolina
RICHARD E. NEAL, Massachusetts
MAXINE WATERS, California
BILL ORTON, Utah
JOHN W. COX, Jr., Illinois

MARGE ROUKEMA, New Jersey
CHALMERS P. WYLIE, Ohio
DOUG BEREUTER, Nebraska
THOMAS J. RIDGE, Pennsylvania
RICHARD H. BAKER, Louisiana
BILL PAXON, New York
CLIFF STEARNS, Florida
PAUL E. GILLMOR, Ohio
TOM CAMPBELL, California
FRANK D. RIGGS, California
RICHARD K. ARMEY, Texas
CRAIG THOMAS, Wyoming
SAM JOHNSON, Texas

BERNARD SANDERS, Vermont

CONTENTS

GOVERNMENT-SPONSORED HOUSING ENTERPRISES FINANCIAL SAFETY AND SOUNDNESS ACT OF 1991

THURSDAY, JULY 18, 1991

House of Representatives,
Subcommittee on Housing and Community Development,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Henry B. Gonzalez [chairman of the subcommittee] presiding.

Present: Chairman Gonzalez, Representatives Oakar, Vento, Frank, Carper, Kennedy, Flake, Neal of Massachusetts, Waters, Orton, Roukema, Wylie, Baker, Gillmor, Riggs, and Johnson.

Also present: Representative Jim Leach.

Chairman Gonzalez. The subcommittee will please come to order.

The first thing I would like to say is that I realize these are difficult times as far as scheduling is concerned, and it has been for some time. The full House agenda is uncertain at times.

Today, I understand there is a measure that will have some votes, but it is not expected to be a lengthy one. On the other hand, I wanted, and I thought I had asked the staff to send out a notice yesterday reminding each member of the subcommittee that we scheduled a hearing for tomorrow, Friday.

I know that is difficult. We have always had problems when it comes to Friday and the House is not in session, and the members, with great understanding on my part, are anxious to get back to their districts.

But in any event, I would urge all the members possible to be here Friday. These are very, very important issues. They happen to emanate from the level of the subcommittee, but it doesn't mean they are any less momentous or important than those we have on the full committee level.

In order to expedite things, we are running slightly behind time, we are about 4 minutes behind, I will just briefly state I will ask unanimous consent to have my opening statement entered in the record, as I have prepared it in writing. It is very brief, but there is no use taking that time.

[The prepared statement of Mr. Gonzalez can be found in the appendix.]

Chairman GONZALEZ. We begin this second stage of the process of providing for the introduction (of legislation) as mandated in last year's budget compromise, with respect to the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and addressing potential regulatory gaps with respect to these entities.

In May, we had the Treasury present testimony, as members will recall, and their recommendations, which are substantial, as to how they would structurally change the secondary mortgage institutions like Fannie Mae, Freddie Mac, and place them under the jurisdiction of HUD.

Now, the Senate, I understand, is also having contemporaneous hearings, so that is helpful. But with that, I will recognize Mrs. Roukema for any remarks she may have.

Mrs. ROUKEMA. Mr. Chairman, I do have a lengthy statement which I will withhold, but distribute to everyone, and particularly those who are testifying today. It is a substantive statement, but I will not take our time at the moment, particularly since I must announce to the subcommittee I will have to be absent for a short period of time.

I advised staff there have been altogether too many conflicts in schedules where inevitably the two subcommittees on which I serve as ranking Member are continuously scheduling hearings. And I have asked staff if they can't please avoid that in the future.

But this is the unfortunate situation I am in today. I will be back and forth here. However, I would state, without question, that this is the most important issue that I see facing this subcommittee in the immediate future—not that there are extraordinary circumstances that cause it to be—I mean, indeed, Freddie Mac and Fannie Mae are doing a fine job, but we have—and a wonderful job which the markets have recognized.

But, nevertheless, there are concerns that Treasury has expressed and certainly that the Congress has expressed in terms of the budget reconciliation requirements, and I am most appreciative of the fact that you, Mr. Chairman, and your staff have worked with our staff on the minority side to move ahead to comply with the schedule that has been set out for us.

So, you are performing admirably in terms of our legislative responsibilities here. As you know, the issue—the issues confronting us refer to the balance between—proper balance, as we see it, between capital and the regulation of the GSEs and their continued successful mission in providing low-cost mortgage funds.

The bill before us today is the product of many long hours of discussion and compromise between the majority and minority staff and the interested parties that are involved.

I have joined you, Mr. Chairman, in this bipartisan effort, because I believe—at least in terms of the subcommittee print, I believe that the bill is a good starting point from which only a few changes or adjustments may be necessary, but then again, that is what we are here today to discover, both today and tomorrow.

It is clear that the primary areas of concern, despite what we have preliminarily agreed to in our bill, there are some areas of concern that continue, at least four and maybe more. I think it was

appropriate to mention them. The appropriate calculations of capital and who should determine those levels.

I believe we will hear some differences of opinion among our witnesses today. You know from our work, both in FIRREA and the recent banking bill that I tend to err in favor of—not err—that is in quotes, "err." But in light of our recent history, maybe that is the way we should be erring.

In any case, that is the area that needs further exploration. The amount of discretion the new regulators should have in setting the capital levels is part of that problem, and also in reviewing the product lines and the need for mechanism for affordable housing—by the way, before I go on, let me say, I understand there are still continuing differences about the regulator, who that regulator should be, and contentions between the departments—I don't know, maybe they have been ironed out.

There is also a need for a mechanism for the Affordable Housing Program. I have certain grave reservations about the issue as it is confronted in our bill. And the issue of pay comparability, I am sure, will come up for discussion. I look forward to the testimony and working with you, Mr. Chairman.

I ask the witnesses excuse me, when and if I have to leave. Believe me, it is nothing you said. Thank you, Mr. Chairman.

[The prepared statement of Mrs. Roukema can be found in the appendix.]

Chairman GONZALEZ. Let me thank you and Mr. Wylie for the introduction of this measure. I am very grateful to you. We do understand your duties and responsibilities. One big, I think, blessing, when you become chairman of a full committee, is that you have to divest yourself of membership in any other committee.

To tell you the truth, I was glad. I will tell you another thing, Mrs. Roukema, I have never grabbed for more than I felt I could adequately chew. Even when I had a choice of five subcommittees, I felt that was too much to handle. I was a member of the subcommittee—rather, the Small Business Committee, since it became a legislative committee, and it was a great area of interest to me, but I tell you the truth, it is very wise that this limitation, whenever it was arrived at. I can recall when the chairman had all kinds of chairmanships besides the full committee. And today, it is the other way around. It is on the subcommittee level that you have multiple duties, but we understand, and we are very grateful for your great work.

Mrs. ROUKEMA. Mr. Chairman, now that you made that statement, I do want to say you are quite correct, and indeed the Republican Conference has adopted a limitation on the number of ranking positions one can hold. And it—when it forced me to make a decision between ranking on the Select Committee on Hunger and ranking on the Housing Subcommittee, I didn't much like it, but in retrospect, it was the wisest thing to do, because there is no possibility for handling all those waiting matters, three ranking positions is too much of a problem.

I will say, with just a little planning, two are quite adequate. Thank you.

Mr. WYLIE. Will the gentlewoman yield?

I would say to the gentlewoman, I have found from past experience that scheduling of hearings is one area, though, where the chairman is certainly on top, and the staff has very little to do with that process.

Chairman GONZALEZ. We do try to meet with various members. Ms. Oakar.

Ms. OAKAR. Mr. Chairman, thank you.

Mr. Chairman, let me first of all compliment you for having these hearings today and tomorrow, and the mark-up we will be having in the very near future. You have always had foresight with respect to critical issues, and this hearing is no exception.

I want to, Mr. Chairman, say that I think the bill you have introduced is a wonderful vehicle by which we can have a jumping point. There is some fine-tuning, but that is the case in all bills.

Essentially, the essential part of the bill which relates to the capital standards and levels are very important. Mr. Chairman, Fannie Mae and Freddie Mac are doing very, very well. I want to publicly thank them for the great job they are doing in Ohio with respect to varieties of programs that have allowed for moderate-income individuals to have access to decent homes.

I want to say that you have a good bill, Mr. Chairman. I have a couple of ideas I would like to share with you in the near future, but basically, it is a solid bill, and I think this hearing and the expeditious manner in which you are going to deal with this subject is the right thing to do.

I want to really compliment you. I also would like to say, I have to be gone for about 15 minutes for a mark-up, and it will be a quick one, in another committee, but I will be right back, because I think this hearing in particular is very important.

Thank you, Mr. Chairman. I thank my colleagues.

Chairman GONZALEZ. Thank you, Ms. Oakar.

Mr. WYLIE. Thank you, Mr. Chairman.

Just 30 seconds to say how much I appreciate our witnesses coming this morning, and to welcome them and to express appreciation for your timely hearing on this very important legislation, which you and Mrs. Roukema and I introduced on July 16.

I realize our witnesses may not have had much time to analyze that particular bill, but it is not too much different, in concept at least, from the bill which Treasury sent up. I think today's testimony will be very, very important in meeting our obligations under last year's Omnibus Budget Reconciliation to report out legislation by September 15, an awesome responsibility we have, and I do look forward to the testimony of our witnesses on H.R. 2900.

Thank you very much.

Chairman GONZALEZ. Mr. Kennedy or Mr. Flake, do you have any brief statements?

Mr. FLAKE. I ask unanimous consent to have my statement placed in the record.

Chairman GONZALEZ. Without objection, it is so ordered.

[The prepared statement of Mr. Flake can be found in the appendix.]

Mr. KENNEDY. As a brief statement, Mr. Chairman, I want to commend you for the bill that was filed yesterday. I want to just hope that the Treasury Department, Mr. Glauber, and others rec-

ognize that while the importance is primary that the organizations, Fannie Mae, GSEs in general reach their financial zenith and are able to, in fact, provide the kinds of services they are designed to, that we don't lose sight of the mission that these agencies are really organized to perform, which is not to simply mimic the private sector, but to provide financing for many of the housing programs for middle- and low-income Americans that are so vitally needed in our country these days.

So, I don't want to just lose sight of those issues by focusing solely on the issue of capitalization. And, also, as I think—I know you are aware, Mr. Chairman, and I hope the Secretary is aware, I am also still concerned about the whole compensation packages that exist for many of the people that are working in these agencies, and thinking that the millions and millions of dollars that we see going to the upper echelon personnel really ought to be better served by providing, I think, most of those people would continue to work at those agencies, even if you cut their total compensation benefits by two-thirds, I think they would still be working at the same agencies and be very happy and satisfied with the salaries they are receiving.

If they got anything double what Secretary Glauber makes, I am sure they would be willing to take those jobs. Anyway, Mr. Chairman, I look forward to our testimony today, and look forward to hearing from all of our witnesses.

Thank you, Mr. Chairman.

Chairman GONZALEZ. Thank you, sir.

Thank you, Mr. Glauber, for having sent us notice that you were going to be 5 minutes late. As it turned out, you were here on time.

In any event, if there is no objection, why don't we recognize you in the order that we have you listed here, and that means that we would recognize Under Secretary Glauber first.

STATEMENT OF ROBERT R. GLAUBER, UNDER SECRETARY FOR FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. GLAUBER. Thank you, Mr. Chairman, members of the subcommittee. It is a pleasure to be here today to present the administration's position on H.R. 2900, the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991.

As you know, the administration has also submitted legislation that addresses the need for enhanced Federal supervision and increased capital for Government-sponsored enterprises.

I would like at the outset to commend this subcommittee and the full House Banking Committee for its attention to this issue, which is of great importance to the taxpayers.

The administration has several concerns about H.R. 2900. These concerns include the lack of primacy for safety and soundness regulation; weaker prompt corrective action and general enforcement powers; the inclusion of an affordable housing program; and most importantly, the proposed capital standards.

Because appropriate capital standards are at the heart of responsible GSE legislation, I will use the remainder of my statement to discuss our specific concerns about proposed capital standards.

With your permission, Mr. Chairman, I would like to read just a portion of the statement, and ask the entire statement be placed in the record.

Chairman GONZALEZ. I should have mentioned your statement—we want to thank you for it—will be in the record. You may proceed.

Mr. GLAUBER. The ability of the regulator to establish and enforce appropriate capital standards for Fannie Mae and Freddie Mac is the single most important regulatory tool needed to ensure their financial safety and soundness.

The capital standards proposed in H.R. 2900 are a serious concern for two principal reasons. First, the proposed capital levels are significantly weaker than those in the administration's bill. Second, the regulator does not have the normal statutory discretion in determining appropriate capital standards.

The minimum capital standard, or leverage ratio, in H.R. 2900 is lower than that in the administration's proposal, even though, as of June 30, 1991, Fannie Mae already clears the administration's hurdle by $100 million, and Freddie Mac is short by $241 million, but is expected to meet this requirement from retained earnings within 1 year.

However, the most glaring weakness, in our view, is the risk-based capital standard that represents the highest level of capital deemed appropriate for Fannie Mae and Freddie Mac. The risk-based capital level in H.R. 2900 is actually lower, by $23 million, according to Freddie Mac's own analysis, than the minimum capital level in the administration proposal.

That is to say, the risk-based capital standard is actually lower than the minimum capital standard in the administration's proposal.

H.R. 2900 also eliminates most of the Director's discretion in establishing adequate capital standards by "hardwiring" in statute the critical assumptions to be used in the stress test. This causes two problems.

First, it limits the Director to using stress test methodology, which is very sensitive to changes in parameters or assumptions, rather than a range of tests based on different methodologies and other market-sensitive indicators.

For example, Freddie Mac's own analysis indicates that a change of only 5 percentage points in two critical assumptions, the loss rates upon default and fixed-rate loan prepayment rates, can result in a swing in equity capital requirements of $1.2 billion, or almost one-half of the current equity of this institution.

Second, the Director would also have no flexibility in choosing parameters, because the worst-case scenario would already be dictated in statute. The Director could not then alter the scenario until after a more stressful housing environment has been experienced and identified, which may well be too late.

If this bill had been law in 1980, the worst-case scenario used would have been 1973, but this would have been replaced 2 years later by events, the 1981–1984 Texas experience that quickly became the newest worst-case scenario.

I think what needs to be done in this case is what we and the House Banking Committee have done in banking regulation; give

the regulator flexibility, both with regard to methodology and the choice of scenario and resulting parameters.

The Director must have flexibility to adopt new methods of analysis which reflect evolving markets and financial instruments and require that Fannie Mae and Freddie Mac be able to survive in a variety of severe, but still plausible, economic environments.

Why would there be opposition to the regulatory flexibility in the administration's bill and which has traditionally been given to financial regulators? Fannie Mae and Freddie Mac say that the regulator will set the capital standards too high, thereby denying home-buyers mortgages at reasonable costs.

This is the issue Mr. Kennedy raised in his statement as well.

We disagree, and I believe the facts support our case. First, demands for such higher capital should rightfully come from the shareholders, not the homeowners. The shareholders of Fannie Mae, for example, have benefited from a corporate return on equity exceeding 25 percent on average for the last 4 years, which has translated into a return for its shareholders in excess of 80 percent per year for the last 3 years to date.

It would surely be possible to retain or raise significant funds to increase capital without causing shareholders to suffer significant distress. In fact, Fannie Mae and Freddie Mac's own internal estimates of their earnings and capital levels over the next 3 years indicate they will have no difficulty in meeting, through retained earnings, the administration's critical capital level, minimum leverage ratio, and any reasonable risk-based capital level.

Further, based on their track record and earnings performance, these two GSEs could easily raise additional capital through equity offerings. GAO corroborates this general view when it writes in its most recent GSE study, "We believe it is possible for Fannie Mae and Freddie Mac to meet increased capital requirements without any resulting increase in mortgage rates."

These are powerful arguments against dilution of the administration's proposed capital standards. We do not have to choose between the taxpayer and the homeowner; we can do both—protect the taxpayer while offering the homeowner mortgage money at fair rates. There does not have to be a choice.

The GSEs have undue concern that the Director will be too zealous in carrying out the prescribed duties by setting the risk-based capital standard too high, each GSE can avail itself of the safe harbor that the administration built into its proposal. This safe harbor would allow the GSE to be deemed to meet the minimum risk-based capital standard.

In conclusion, let us learn at least one lesson from spending $200 billion on the savings and loan debacle: That meaningful capital standards, when the taxpayer could be at risk, must be maintained.

GSE capital standards must be sufficient to make those enterprises safe to the taxpayer. Anything less would be a failure in our responsibility to the taxpayer. The administration will not support the imposition of capital standards which appear to have teeth, but in fact do not provide sufficient protection.

Mr. Chairman, the housing agencies are the largest and most visible of the GSEs. The legislation drafted to deal with these agencies will set the standards for the other GSEs. Because these GSEs

have established such credible records in the investor marketplace, we have the opportunity to demand that they build strong enough capital on their balance sheets to protect taxpayers and at the same time deliver their services at rates which make mortgages available at reasonable cost to homeowners.

We do not have to choose between protecting the taxpayer and protecting the homeowner, and we should not.

That concludes my statement. I would be happy to answer any questions the subcommittee might have.

[The prepared statement of Mr. Glauber can be found in the appendix.]

Chairman GONZALEZ. Thank you very much, Mr. Secretary.

Mr. Weicher.

STATEMENT OF JOHN C. WEICHER, ASSISTANT SECRETARY FOR POLICY DEVELOPMENT AND RESEARCH, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. WEICHER. Thank you very much, Mr. Chairman.

It is a pleasure to be here to discuss the administration's proposal to reform the regulatory structure of Fannie Mae and Freddie Mac, and also discuss the legislation, H.R. 2900, which you introduced on Tuesday.

As you know, on May 28, the administration submitted legislation to Congress for regulatory reform of GSEs. HUD believes this proposal would significantly strengthen and improve our regulatory authority to oversee Fannie Mae and Freddie Mac.

The essence of the administration's proposal is that it provides for the primacy of safety and soundness regulation of the GSEs, while taking advantage of HUD's expertise in housing and providing for the necessary coordination of program and financial regulation.

We are glad to see that H.R. 2900, which you introduced on Tuesday, has many features in common with the administration's proposal. I want to enumerate some of these.

First, HUD would continue to be the regulator of Fannie Mae and Freddie Mac. As you know, Mr. Chairman, some analysts have requested whether HUD can be an effective, independent regulator. We believe we can be. We believe we have demonstrated our ability over the last 2 years.

Second, HUD would acquire significant new enforcement powers, including the authority to issue cease and desist orders, appoint conservators, restrict dividends, restrict growth, and assess penalties for failure to report and comply.

Third, HUD would acquire the authority to charge Fannie Mae and Freddie Mac for the cost of regulatory activity. Both enterprises opposed this authority in the 1992 HUD appropriations bill, where it was proposed as part of the President's 1992 budget.

Because they are both profitable, we believe it is fair that they bear the full costs of regulation, made necessary by the special benefits they receive from the Federal Government and by the risks to the taxpayer posed by their activities.

We believe the coverage in the bill should be extended to all of HUD's GSE regulatory costs to enable HUD and other financial regulators to operate on the same basis.

Fourth, a separate office would be set up within the Department with sole responsibility for safety and soundness regulation of Fannie Mae and Freddie Mac, headed by a Director reporting to the Secretary.

However, in the fundamentally important matter of capital standards, we do believe that H.R. 2900 is not adequate. Both the administration's bill and H.R. 2900 contain a three-level capital structure with specified capital standards for each level, and sanctions associated with failure to meet those capital standards.

However, the administration's bill has, we believe, stronger and more appropriate standards for capital adequacy.

H.R. 2900, while it builds off of the administration's standards, weakens those standards to the point of ineffectiveness. Both the minimum and critical capital levels are substantially lower in H.R. 2900 than the administration proposed.

The minimum core capital level standard for mortgages is reduced from 2.5 percent to 1.5 percent of on-balance sheet assets. We calculate that the net effect is that the minimum capital level is reduced by 10 percent for Freddie Mac and 25 percent for Fannie Mae, compared to the administration's bill.

Mortgages are much riskier than mortgage-backed securities. They are subject to interest rate risks as well as credit risks. The bill would not require any increase in standards, while nearly every independent analyst agrees that Fannie Mae and Freddie Mac are thinly capitalized, and a higher level of capital is desirable.

In addition, H.R. 2900 codifies the conditions of the stress test methodology in statute. It provides specific tests for credit risks, and for interest rate risk to determine the amount of risk-based capital. HUD does not advocate the establishment of precise stress tests in the statute, because economic conditions can change.

We believe the design of stress tests for setting the risk-based capital levels should be left to the discretion of the regulator.

We also question whether the particular test in the bill adequately addresses the possibility of severe economic shocks. The tests are somewhat ambiguous, but they are clearly less stringent than Moody's, which has been the standard used in many analyses.

The purpose of capital requirements should be to provide a cushion against severe economic conditions even though they may not happen. The stress tests in the bill do not meet this criteria.

Other aspects of the capital standards raise concerns. Capital is required to protect against interest rate changes of the lesser of 500 basis points, or a 50-percent change in either direction. In the past 20 years, the mortgage rate has varied from 7 percent to over 17 percent, yet this test would only cover an increase from today's rate to about 14 percent.

To cover management and operation risk, the bill allows 20 percent of the amount required for credit risk and interest rate risk. The damage that can be done by management mistakes is surely potentially more severe than 20 percent of the risk measured by

changing economic assumptions. The capital requirement, therefore, should be higher than 20 percent.

The exact amount should be left to the discretion of the regulator.

Mr. Chairman, over the last few years, new public policy concerns have arisen over the safety and soundness of the GSEs. Congress has required five separate reports from the Treasury Department, CBO and GAO in the last 2 years alone.

While these reports agree that Fannie Mae and Freddie Mac do not pose an imminent threat of loss to the Federal Government, they also agree that the agencies are thinly capitalized and current capital requirements are inadequate.

And they agree that stronger regulatory authority is needed, including greater ability by the regulator to set capital standards, clearer regulatory authorities governing program approval, stronger enforcement powers, and the ability of the regulator to charge for the cost of regulation.

The reports differ with respects to the appropriate regulatory structure, but they agree on the fundamentals of appropriate regulation. The administration's proposal provides the resources and authority for effective regulation of Fannie Mae and Freddie Mac.

That concludes my opening statement. You have my full statement for the record, and I will be glad to answer any questions you or any member of the subcommittee might have.

[The prepared statement of Mr. Weicher can be found in the appendix.]

Chairman GONZALEZ. Thank you very much.

I am sure the capital issue is going to be the main discussion point, and in a way that can be regretted, because I think—of course, as vital as that is, I am not denying it, and I think there is no argument, at least not on my part, that we want the same thing.

We want solid capital standards and requirements, but the difficulty is in the disparate and contradictory statements over the course of the discussion on this issue for the past year, year and a half, or two.

Now, I notice, Mr. Glauber, in the testimony you gave the Ways and Means committee, Mr. Pickle, who is the author of the study required in FIRREA and last year's budget, that you had then just one interest in adequate capital or, rather, safeguards to avoid any tenuousness, as I think every sector of our financial society is facing.

Any entities having to do with financing in our country—and it is going to be far more acute than it now appears, as I see it, because nobody is factoring in the forces now that are upon us, and have been for some time, and over which we no longer have any control, and that is the external or international forces.

But in your appearance before that subcommittee, Mr. Pickle said that if the GSEs don't have all the responsibility as the banks, then why shouldn't they meet the standard. And you replied they shouldn't be overcapitalized, and you cannot drop the capital standards of banks onto the GSEs.

Then Mr. Pickle says, you need a good, solid reserve and don't you agree they need to be better capitalized? You said, I don't disagree.

Now, the question here is, as anxious as we are to have adequate capital and avoid undercapitalization, I think here you admit that the equal mistake would be overcapitalization or a strained—overly-strained requirement that could have, in another sense, the same effect.

And a dilatory effect on the institutions. Now, in your testimony, you said, H.R. 2900 is deficient in that respect, in that it doesn't require enough capital from Fannie Mae and Freddie Mac. I am going to say that if there is anything that I have been shouting about—not now, and not 10 years ago, but as far back as 1966, I can't help it if there is not much attention paid to these issues until there is a crisis aboard.

I think we want the same thing. The only question is, how can we be sure that we are providing these institutions with the adequate capital standards, and that comes to definition. What is the adequate capital standard for Fannie Mae and Freddie Mac, or in addition, what is a reasonable risk-based capital level?

Now, a while ago, you mentioned the fact that a slight variation—I think you said 5 percent in your vicissitudes, these activities with respect to the—I guess the portfolio.

Mr. GLAUBER. Yes.

Mr. Chairman, in these stress tests, as you know, there are a number of assumptions that have to be made, and small changes in these assumptions produce very large changes in the capital that the model would require.

Chairman GONZALEZ. In our bill, Mr. Brendsel tells us that as they interpret our bill, that Freddie Mac would be required to add $1.5 billion of capital. Now, that is the exact amount you said would be the dislocation if you had this worst-case situation. So, if we cannot state what and institution should have in the way of capital, then how can we—if we can't be told, with some degree of precision—not exact precision—these things, as you say, are predicated on assumptions, I think the reasonable thing to do is what we should have been doing 15 years ago, when we had the writs.

The real estate investment trust scandals were the first indication of what was going to happen. When you referred to Texas in 1981, 1982 and 1983, we had the recession of 1981–1982, in which the pressures had built up. Texas just happened to be the forerunner because of some other things that had happened with respect to the other markets, but it is now national.

The Texas taint is now nationalized, and that was predictable, and we said so in 1983–1984. I was making speeches on the House floor as early as 1983, soon after the effective date of Garn-St Germain, and in January 1984 reporting the land flips, the real estate flips, the fast, speculative restructuring of State-chartered S&Ls, and nobody could care less, but they are in the record.

I am not saying this now in retrospect and hindsight. Why, because—and I don't claim to be an expert, but I do know how to add. And I did have 4 years of college math, and I think that there are some things that we can reasonably ascertain, and this is what we were trying to do in H.R. 2900.

So what I would like to see would be some input you could give us as to how in that respect you would suggest language that would fortify that capital standard as you see it.

Mr. GLAUBER. Well, Mr. Chairman, first, let me say, there is so much in what you said in your statement with which I agree, and what is known to all is nobody has taken a more effective leadership position than you in demanding of financial institutions high levels of capital.

You did that when we did the FIRREA bill. As far as I know, you have always done that. I think there is a misconception in discussing capital standards for these institutions. There is the sense that somehow, we have to choose between high levels of capital and safety, and providing services of these institutions to homeowners at a fair price, and I don't think we have to make that choice.

Chairman GONZALEZ. I agree with you. As a matter of fact, when the outcry occurred with respect to the S&Ls, I had been put down as a big champion of S&Ls like my predecessor, Mr. Patman. Mr. Patman was Mr. S&L. That wasn't the case.

Are you for the little guy, so you can get mortgages? Of course. How can you be for the little guy if you are exposing them to the sharks, in an unworthy enterprise, even if it is labeled S&L?

I agree with you, the choice doesn't have to be between the shareholder and home purchaser. The reality is that the people that are in the shareholding enterprise section of it are not looking at it from the pro bono standpoint, and therefore, this is where we should come in as the policy-making body, supposedly looking at the overall picture.

As I see it, as dishonorable as it is to say you don't have to make that choice, it won't do any good to have a failed Freddie Mac or Fannie Mae for anybody, homebuyer, purchaser, one in the same, and I think this is what we want to do, I think, with the best of intentions.

I notice over in the Senate hearings, the big issue was whether or not HUD could do the job. Well, this is why it is necessary that we sustain a level of hearings that will adduce as much information as possible so the members can make up their minds on the basis of as much knowledge as it is possible to gather.

I have some other questions, but I think I have long overextended my 5 minutes.

Mrs. Roukema.

Mrs. ROUKEMA. Let me defer to Mr. Wylie, please, and I will take up my questions at a later time.

Mr. WYLIE. I thank the gentlewoman.

I want to follow up on what the chairman was talking about. I think the chairman has put his finger on the key issue. I think it is as much a matter of definition as anything else as to what is adequate capital, and you are shaking your head affirmatively there.

It is more of a definition as to how much capital we should have, as opposed to your concept, which is a limitation—I am not sure I am putting that in the right frame of reference. The chairman said he had 4 years of math in college, and I was going to be a math teacher and decided not to do that, and enlisted in the Army instead.

So—but we attempt in our bill to establish some minimum capital standard in H.R. 2900. The GSEs tell us they can work better with a minimum capital standard or with a defined capital standard, rather than what they regard as a sort of a moving target.

And I tend to agree with you, there probably should be some regulatory flexibility. I have heard your testimony in that regard.

I wonder why the Treasury can't come up with a level of capital that they think should be required, given the current risk-based profile. We are only talking about two institutions, after all.

Mr. GLAUBER. Well, first, I think there really are—if I interpret what you are saying, two issues. One is what should we set as a minimum, and how can we set an adequate level, which presumably is above that minimum? There is a concern lurking in the background, if we aren't more precise, the regulators could impose unfair burdens on these institutions.

First, we disagree with the minimum. We think the minimum is too low. The minimum in the bill is set at a level which would say the current level of capital for these institutions is adequate. It meets the minimum, and many people think it doesn't.

On how you set an adequate level above that, I think the reason that we appeal for flexibility is precisely the reason that it is done with banks and in banking regulation, that it is impossible to write into law hardwire specifications that won't be washed away by the events of time.

What seems sensible now, in light of the kind of securities that are issued, will very quickly not seem sensible as events introduce new kinds of securities and new operating procedures. So, I think it really doesn't make sense to hardwire that precisely.

Now, that immediately raises the question, if you don't—if you aren't precise, will not the regulators have carte blanche to do something which is irresponsibly severe, and maybe the way to deal with that is not only to set a minimum standard, but to set a maximum, set a ceiling as well as a floor, and that can be done in a variety of ways.

We proposed one way to set a ceiling, and that was the safe harbor provision. To say notwithstanding whatever the regulators may set down as regulations if you qualify under this provision, you have met the standards. There are other ways to do it.

But if you ask me, could we not agree on a measure of adequate capital, I guess my answer is I don't think we could write down a number. We could write down perhaps some more refined procedures, and we could set an upper and lower limit, perhaps, inside of which the regulator would have discretion to respond to the changing events and changing operating policies of these institutions.

Mr. WYLIE. Could you elaborate a little bit as to why you think the regulator needs this flexibility in creating the so-called stress test?

Mr. GLAUBER. I think for two reasons: One, the kinds of securities that these institutions issue is going to change over time. The financial markets are innovative, they are going to invent new securities.

These institutions are going to want to issue them. In order to deal with those new kinds of securities, there needs to be flexibility.

The second reason there needs to be flexibility is, I guess it is very difficult for me to understand how we would want to put in legislation that the regulators should use this pack of computer cards and use this window of history as the basis for determining what is adequate capital.

The problem with using specific periods of history is that they are constantly replaced. When we talk about the most stressful time we have ever seen, we may see a more stressful time, and we would wish we hadn't nailed ourselves to that particular specification of a period.

If I might, there is a wonderful—wonderful example. It is a tragic experience, but in the North Sea, when they were building platforms to drill for oil, they built them to be high enough to withstand the highest waves that had been experienced in 100 years. Several years after they built one of these and attached next to it a hotel facility, that hotel facility capsized because they experienced waves higher than they ever experienced in the past 100 years.

If we nail into the legislation a specification that this is the worst event that we will see, time and time again, we have seen that isn't the fact. It is washed away by a more serious event.

Chairman GONZALEZ. Will you yield to me, Mr. Wylie?

Mr. WYLIE. Yes.

Chairman GONZALEZ. On the other hand, you said a little while ago, perhaps one way would be to set a ceiling as well as a floor. In H.R. 2900, this is what we are trying to do. We thought we were setting a parameter for the regulator within which is discretion, because just like in the case of the oil platform, in our case we aren't dealing with the waves, we are dealing with human beings, and we have got to legislate as if the legislation is going to be carried out by the devil, not by angels.

So this is the reason we thought we would have parameters within which the judgment and discretionary factor of that regulator would be appropriate. That—thank you very much.

Mr. WYLIE. The chairman is making an excellent point. I would just follow up on that and suggest, if I understand your testimony, you don't think that our upper limit is enough, and may I respectfully suggest, would you have a suggestion as to an upper or lower limit, and maybe we can use that as at least a negotiating position?

Mr. GLAUBER. I think we put our finger on exactly the issue. What is the right balance between specificity and flexibility? Our view is there just isn't enough flexibility, and I think people can disagree. I have one approach, and I cannot give you an exact number, because clearly, the number depends on the kinds of assets that the different institutions hold, their operating procedures, so I can't give you a number.

We have always been intrigued by the idea that private companies regularly get calibrated as to the amount of risk they have by rating agencies, and we don't suggest that we should turn this authority over to rating agencies, but we could imagine the regulator, in setting these regulations, could be guided by equivalent risk

levels to other institutions in the marketplace that have been calibrated by rating agencies.

I think that might be one effective way, Mr. Wylie, of getting some fix on what is adequate, because that is really what we are talking about.

Mr. WYLIE. That really is what we are talking about, and maybe we can discuss that further. My time has expired. We ran into this in our FIRREA legislation as to what adequate capital standards should be for S&Ls.

There were those that argued goodwill should be included as part of the test. I think what we should know is what factor should be included in the test.

Mr. GLAUBER. If I might pick up on something you just said, Mr. Wylie? In FIRREA, what we have traditionally done is set minimums and give the regulators discretion above those minimums. And it is really that structure that I think is the appropriate structure.

Now, we can try and refine that more so that the regulators aren't given excessive discretion, but I think we have to be careful not to go too far and totally tie their hands in a way we might regret later.

Mr. WYLIE. That is true. There is some analogy except when we talk about capital standards for banks, we are talking about 14,000 banks of all sizes and with reference to S&Ls, we are talking about 2,100; in the case of GSEs, we are only talking about two.

Mr. GLAUBER. That is a fair point. I think we can do more custom tailoring when you only have two clients. I think that is fair.

Mr. WYLIE. Thank you very much.

Chairman GONZALEZ. Mr. Kennedy.

Mr. KENNEDY. No questions at this time, Mr. Chairman.

Maybe I could yield to Mr. Neal or whoever would be next, and come back at the end of the questioning. Would that be possible?

Mr. NEAL OF MASSACHUSETTS. Mr. Chairman, I have one question for Mr. Glauber. I think, first of all, we would all acknowledge the GSEs have worked reasonably well. The experience I had as a former mayor of a major city, they play a very important role.

By and large, I would say as an entity, they have done far better than most of the entities that you deal with in that capacity of running a major city.

Mr. GLAUBER. Absolutely. Again, our comments on issues of safety and soundness are not meant to reflect in any way upon the performance of these agencies.

Mr. NEAL OF MASSACHUSETTS. Your position is sound and reasonable, particularly in light of what has happened in the Banking Committee. We have witnessed profound changes across financial America. In the Treasury's legislation, there was no mechanism by which the regulator could assure additional capital came from earnings or was raised in the markets and not passed through the home owner.

Should a regulator be given the power to review fees and charges to make sure the additional capital costs are not passed on to the prospective home owner?

Mr. GLAUBER. You put your finger on an issue that floats throughout these hearings, and the issues that you are considering. It is related to the question of whether or not you impose restrictions on the compensation of people. To be very frank, it is not the issue on which we focused.

Our mandate you gave Treasury was to look at safety and soundness issues, and not on the regulation of charges, compensation, and those related things. I think that is a very difficult trade-off. These are private institutions and traditionally, what we say with private institutions is that the marketplace regulates them.

On the other hand, these are private institutions that operate in a particular market where the two of them dominate that market. The market forces are somewhat diluted from what they would usually be.

Mr. NEAL OF MASSACHUSETTS. I guess the GSE's have been successful because of the term we throw around here all the time, reasonable costs, and I think we should be mindful of that, obviously as the debate ensues. Thank you.

Mr. GLAUBER. I agree with you completely on that.

Mr. NEAL OF MASSACHUSETTS. That is the only question I had.

Chairman GONZALEZ. Will you yield to me? You have a little time.

Mr. NEAL OF MASSACHUSETTS. Yes.

Chairman GONZALEZ. I think there is a fundamental—I don't know what to call it, philosophy, what have you. It just seems to me that when we try to have all the good of being called private, with all of the subsidy of being public, that who can win against that combination?

This is what has been happening in the other areas of our financial activities. If they do dominate the market, Mr. Neal, it is because they have that little advantage that the Federal Government gives them, which I say is a subsidy.

Mr. NEAL OF MASSACHUSETTS. That is not a little advantage.

Chairman GONZALEZ. You can call it whatever you want to. Otherwise their competitors in the private market would be on an even basis, and I think we have got to make it clear that we are not talking about an out and out private enterprise, so that when compensation comes up as to the officials of these entities and they say, oh, well, but we put on our private hat here. We want to get the same as some big corporate head over here, and maybe more. I think that Congress here has got to make up its mind.

Maybe we ought to go back and take up President's Reagan's and Dave Stockman's first recommendation to us on February 8, 1981, that we "privatize" these two secondary mortgage institutions. That was what they wanted on that basis, that too much national credit was being allocated to the housing sector and to wit the secondary mortgage market. So we better realize that if we are here it is because the Government and the Congress has a responsibility in view of the fact that these are quasi-public enterprises, inasmuch as they are making use of public funds.

Anyway, you want to look at it. We can be very polite and say it isn't, that it is just something else, but that is what it is. Thank you for yielding, Mr. Neal. I just think we have to get back to the basics.

We have stayed away from basics in our country, and we have to get back to basics and calling things by what they are and not deceiving ourselves because of some convolutions in ideology and philosophy and private and public and what is relief, and what isn't, and what is socialistic and what isn't.

That is nonsense. We have got to get back to the basics, and the basics are very simple. They are outlined fully in the Constitution. Anyway, thank you very much for yielding.

Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

I am really trying to understand the distinction between an absolute capital standard and the stress test as outlined in the legislation. As has been given to me, if the stress tests were put into effect as proposed under H.R. 2900, that the current evaluations would establish about a $750 million cushion under the performance of the stress test above what minimum capital requirements might be.

Now, I am trying to get a handle on whether or not there are modifications to the test that make sense in light of the comments made in both of your statements that there are elements of the test which don't seem to really reflect worst-case scenario because I don't think an absolute capital standard, given the history of S&L's and banks always makes sense.

You could be at 3 percent in an S&L. If you got there by going down from 6, that is not a good test. If you are at three and you got there from zero, that might be an indication you are going to be OK, just in a very broad sense, so that an operational analysis, a cash-flow analysis is a much preferred system to determine good from bad.

The stress test seems to be moving in that direction, but I am not comfortable yet that the stress test does what maybe we ought to be doing. For instance, the requirement is an 8-year assumption on worst-case scenario.

You raised the issue in one statement that the origination period during which the highest default experience occurs is one possibility or 3 years during which the highest percent of defaults occur, regardless of when the originations took place, and whether it is A or B, B, to me, is obviously the way you want to go.

What I am trying to lead up to is are there specific adjustments that we can make to the stress test to create a clear managerial tool that sets reasonable standards against the most onerous of conditions, because I think we do have to recognize that this is a business entity which has a public responsibility, and if we leave it in an unclear definitional status, how do you make your business plan to have sufficient capital to meet your regulatory standard, and not at the same time deter from your public mission to provide financing for housing?

I am just looking for specifics. I know you don't like having— maybe I am speaking directly to Mr. Glauber here, having it in statute, and I know there is some concern about stress tests generally, but if we were going to have one at all, what would be the elements you would change in what we have in front of us to make it a tolerable or a reasonably acceptable test by which safety and soundness could be assured?

Mr. GLAUBER. Well, you have raised all the right questions, and I must tell you that my answer has to be I would not rely singly on a stress test. I think there are two fundamental problems with stress tests. One is that they are very sensitive to the assumptions you put in.

Small changes in the assumptions yield very large changes in the required capital levels. I gave as an example in my testimony, changing from 30 to 35 percent, a couple of the input assumptions in these models changes the amount of required capital by over $1 billion, so those are big changes for small changes in the assumptions.

The second problem I have with stress tests as the single methodology on which you rely is that they always are looking backward at a particular piece of history, a particular portion of time, and the problem is that what was and appeared to be the most stressful situation you have ever seen seems constantly to be washed away by a new, more stressful situation.

If we had set adequate capital levels on the basis of the most stressful situation that we had ever seen back in 1979, we would have been wrong 2 years later.

Mr. BAKER. But the point there, though, is that whether you are doing it with a stress test, which is composed of a number of variables that we agree are the appropriate variables, a capital standard is achieved by someone making an external judgment as to what current conditions make the reserve a safe reserve, and we don't reserve 100 percent against all losses, and we certainly don't reserve zero percent, so somewhere between the two extremes we come to a negotiated agreement.

What I think I am hearing you say is that the negotiated agreement can't be set by formula. It needs to be set by regulators, and the concern is what elements are you using to set the level of capital reserves that we are not using in the stress test?

For example, somewhere in here there is a comment that—I don't have it immediately in front of me, but the general comment is that there is external information that you have about the condition of Fannie and Freddie which indicate to you that the reference that they propose are not sufficient, even though they are in good shape today.

Mr. GLAUBER. I don't want to say it that way. I think the stress test should be an important ingredient, but the way these institutions are managed, the operational, the management risk is an important ingredient into that.

I don't think you want to pin the entire process of setting capital standards to a pack of computer cards.

Mr. BAKER. But we could exclude managerial and capital risk from capital standards because no matter how good your capital requirements are, if you got a bad guy running the business, you are in trouble.

Mr. GLAUBER. But it is also true that if you run your business in a way that responds more slowly to changes, you want a bigger buffer of capital to guard against that.

Mr. BAKER. Mr. Chairman, I know my time has expired but just one last question, if I might.

I am sorry. Is there a number? If we are going to say today what our capital standards should be, what is it?

Mr. GLAUBER. I cannot give you a number, first because the number would be different for Fannie Mae than it would be for Freddie Mac because they are different institutions. They hold different kinds of assets.

Mr. BAKER. We have two numbers, one for Fannie, one for Freddie.

Mr. GLAUBER. It is not my job to give you a number. What I think I can do is give you a process. This is not totally uncharted waters. The private markets do this all the time. They make judgments about which institutions are riskier than another and whether an institution is too risky.

They do this all the time, but they do it by a process that goes beyond relying on single test with one single period in history. That is all I am saying. I think you need more——

Chairman GONZALEZ. Ms. Oakar.

Ms. OAKAR. Mr. Chairman, very briefly. Thank you again for your patience with me. For the record, gentlemen, could you specifically state what role the Department of HUD and the Department of Treasury, under current law have with respect to regulating Fannie Mae and Freddie Mac?

Mr. GLAUBER. I don't think I did in my testimony. I will be happy to do so. Let me speak for Treasury. We, I think, have a traffic cop role. We sometimes intervene in the timing of the issuance of securities by these enterprises simply to make certain that they don't disrupt the market. This is what we view as our role in regulating these institutions today.

My colleague, I think, can speak for HUD.

Mr. WEICHER. Ms. Oakar, we are the regulator of Fannie Mae and Freddie Mac. We have been the regulator of Fannie Mae since the Charter Act was passed in 1968. We have been the regulator of Freddie Mac since FIRREA was passed in 1989.

We are responsible for approving new programs under the Charter Acts. We are responsible for setting capital standards under the terms of the Charter Acts.

We are responsible for reporting to you annually on the condition of the institutions and providing other information as you request.

We have had those responsibilities, as I have said, for some period of time in the case of Fannie Mae. We have been exercising them, we think, vigorously and effectively over the last 2 years. We are the regulator.

Ms. OAKAR. Two years ago in the wake of the S&L crisis, Congress, of course, was a little reflective about the future of other agencies and quasi-government agencies like Fannie Mae and Freddie Mac, and that they might potentially become a risk. And as you know, there have been eight reports from five different government agencies related to Fannie Mae and Freddie Mac, and each of the studies reached a very positive conclusion, which was somewhat refreshing in view of the problems that we have seen with other institutions.

I think my chairman unfortunately couldn't be here during your discussion of the capital standard, but I think the chairman is dead

right when he makes the very important distinction between an S&L and a financial institution and Fannie Mae and Freddie Mac.

These agencies were founded 2, 3, 4, or 5 years ago with the specific mandate related to access. They are very unique agencies, and I think the chairman in his bill has enough foresight to indicate that there should be a capital standard, which is the reform that may or may not be necessary, but it is in there and it is pretty solid. And I would think that you could have such a thing as overkill when these institutions have indeed survived eight different reports and tremendous scrutiny, but we are faced with the task of modernizing capital standards and the regulatory system under which they were founded, and I think that is what we are trying to do in a balanced way.

Your bill, to be honest with you, is not as strident as I expected it to be in view of the fact that in the past the administration has wanted to wholesale privatize these agencies. But nonetheless I feel that the bill, with some fine-tuning, is pretty much of a balance between overkill and having a standard to place them under. And whether they like that or not, I think that is the right thing to do. So I wanted to compliment the chairman and just comment on your exchange with him.

But you do, in fact, regulate and have oversight, just as Congress, of course, has as well. Thank you.

Chairman GONZALEZ. Thank you, Ms. Oakar. Are you ready, Mrs. Roukema?

Mrs. ROUKEMA. No, Mr. Chairman.

Chairman GONZALEZ. Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman.

Let me say before we get too enthused about the subcommittee draft, it has been my view over the years, quite frankly, that the Department of Housing and Urban Development has been more lax than stern in regulation of these institutions. Having said that, we should take very seriously coming from a lax direction, in this Member's view, the statement of Mr. Weicher this morning.

This is the Department of Housing and Urban Development, which the agencies have wanted to have as a regulator in fear of having Treasury as a sterner regulator. The Department of Housing and Urban Development has told this subcommittee this morning that "The standards set in this bill would be a step in the wrong direction. Mortgages held in portfolio are much riskier than mortgaged-backed securities. They are subject to interest rate risk as well as credit risk."

And I go on, "We question whether the particular test specified in the bill are relevant, comprehensive, and adequately address the possibility of severe economic shocks to the GSE." In other words, what I consider to be an incredibly lax regulator has said that this Congress wants to set an even laxer standard, and I think we ought to be very concerned.

Let me just ask a couple questions in this regard because apparently there are concerns on this subcommittee for the stockholder. You know, in the last few years, Fannie Mae stock has tripled, management salaries have been fairly impressive.

I mean, if you relate them to the Presidents of the United States who have much lesser jobs, and I think the subcommittee ought to recognize that.

Now, I would like to ask Mr. Glauber, just to set a perspective, in a calculating sense, what do you believe is the subsidy of the U.S. Government, that is the U.S. taxpayer, to Fannie Mae per year?

Mr. GLAUBER. Well, I can't answer that. We were asked, I think, by Mr. Gradison to make a calculation. It was not for Fannie Mae. It was for all GSEs. And I think we calculated the number at between $2 and $4 billion a year.

Mr. LEACH. And they earned $1 billion last year. The reason I raise this, and I wish this subcommittee would think about it seriously, the U.S. Treasury has calculated that these institutions got a $2- to $4-billion subsidy and they made about $1 billion a year, maybe a little more.

That is not impressive, if you get a $2- $4-billion subsidy. It says something else. It says that when you compete with that size of subsidy, someone is likely to be injured and that somebody has implications for all of us in this room because that somebody is the financial industry that isn't subsidized—the savings and loan industry as well as the commercial banking industry for which we now have a massive Federal safety net.

So as these institutions grow in size, taking on an enormously larger segment of the market with the Federal subsidy, that hurts the earnings stream of people with the Federal safety net. In other words, that they may get a $2- to $4-billion subsidy by the Treasury's calculations, but it could be another multi-billion-dollar loss to the taxpayer because of the loss to the Federal safety net.

Is the Treasury prepared to tell us what kind of additional losses too generous treatment of these institutions may have for the taxpayer because of the Federal safety net to whom they compete?

Mr. GLAUBER. We have never made that calculation, but I think that the logic of what you said is certainly——

Mr. LEACH. Could I request that statistic from the U.S. Treasury formally?

Mr. GLAUBER. We will endeavor to provide it to you, Mr. Leach.

Mr. LEACH. I would appreciate that. Now, let me go on. What percentage of the marketplace does Freddie Mac and Fannie Mae now occupy in terms of the secondary market for mortgages?

[The information referred to can be found in the appendix.]

Mr. GLAUBER. I believe the answer is somewhere above 90 percent, but Mr. Weicher has a better answer than I do.

Mr. WEICHER. In terms of the secondary market, they are essentially the only securitizers of mortgages.

Mr. LEACH. Without a Federal subsidy, would there be other market participants?

Mr. GLAUBER. Well, there are oftentimes more than two participants in the marketplace, yes.

Mr. LEACH. They have 90 percent, and with the subsidy it is pretty hard for other participants to compete; is that not right?

Mr. GLAUBER. I think that is a fair statement.

Mr. LEACH. Mr. Weicher, may I ask you and Mr. Glauber, do you think the antitrust laws ought to apply to these two institutions?

Mr. WEICHER. Mr. Leach, I am not an antitrust lawyer, and I would leave that, I think, to the Justice Department. I would simply suggest that these institutions have been created by act of Congress to serve specific purposes and been given specific privileges not available to purely private firms.

I do not know how that plays against the antitrust statute.

Mr. LEACH. Do you think the antitrust laws should apply or not, Mr. Glauber?

Mr. GLAUBER. I guess I am not prepared to make a statement on that. Again, I would underline what Mr. Weicher has said, that Congress has chosen to endow these institutions with special privileges.

Mr. LEACH. I appreciate that.

Could I ask for formal considered opinions from both of your institutions on whether the anti-trust laws can apply, should apply?

Mr. GLAUBER. Of course.

[The following information was subsequently received.]

From Mr. Glauber:

We understand from conversations with representatives of both entities that the entities already consider themselves subject to the antitrust laws.

From Mr. Weicher:

Legal counsel advises us that FNMA and FHLMC agree that they are subject to the antitrust laws. Treasury and HUD lawyers concur with FNMA and FHLMC.

Mr. LEACH. Finally, just let me conclude, because I want to comment on something the gentle lady from Ohio has mentioned.

I think she is generally right that the administration has pushed in a privatizing direction for these institutions. But interestingly, Congress pushed further, and let me stress this: In FIRREA, Congress turned over control of Freddie Mac to its preferred stockholders. Treasury opposed this move and suggested that Freddie should be governed by a board, a majority of whom would be Presidential employees.

Since enactment of FIRREA, when Congress gave control of Fannie Mac to its shareholders, the number of mortgage securities it has issued have declined, and that was one of the great intents of Congress, to push them in the mortgage-backed area.

The fees it has charged on its mortgages have increased, with the cost of such increases being picked up by the homebuyer.

At the same time, the stock and salaries of top management have gone up rather substantially. It would appear that the winners of the new Board plan seem to be Wall Street stockholders and management, and the losers—to some degree, although to some degree they have also helped—the American homebuyer.

So I would like to ask Treasury, do you think Congress should move back in the direction of your previous position of returning control of the Board, for example, or Freddie Mac of Presidential appointees?

Mr. GLAUBER. I think we would continue to adhere to our previous position.

Mr. LEACH. So you would argue that if we are going to have a new substitute in this direction, we ought to move in that direction.

Well, my own sense is that it ought to be seriously considered, as long as they get a Federal subsidy. Maybe give them a choice, take Federal out of the name and take away the Federal guarantees if they are going to operate as a private sector enterprise.

Now they have the best of all worlds. They have got the Federal guarantee, and the privatizing of profit with the socializing of loss, which is what we have had before.

But in this case it is socializing the loss in a whole spectrum of other enterprises, as well as with itself. What we have is a new gargantuan structure of two institutions that are competing with a Federal subsidy against a larger number of private enterprises.

Now, speaking personally, I think these are two exceedingly well run institutions. And in some ways, they have played a very important role in helping institutions that got over-leveraged to take some of their assets off their balance sheet.

But in the years ahead, they are going to be far more competitive and detrimental to the institutions that they have helped in the last couple of years. The nature of the industry has changed so much in the last few years that I think Congress must recognize we have a different beast to look at—to appraise and to overview—and that our simple giving in to these two institutions at every turn ought to be examined very careful.

Thank you.

Chairman GONZALEZ. Thank you.

The last time we had a hearing—and I will urge the gentleman if he can to be here when the Chairman and CEOs are here in the next panel because the gentleman referred to guarantees and subsidies, and we had an endless—we had a finely limited time as to whether there was an implicit, explicit guarantee or no guarantee.

So I will be interested in seeing Mr. Glauber's reply to that question.

Mr. Kennedy, were you waiting to be recognized now?

Mr. KENNEDY. Sure, please, Mr. Chairman. Thank you.

Mr. Glauber, I was interested, obviously, and concerned about the dual role of Fannie Mae and the GSE's in general in terms of obviously people are concerned, and I am concerned about the safety and soundness.

I am also concerned about the mission of the organization and the fact that as we strengthen safety and soundness, it seems that we potentially weaken their ability to address the concerns of the poorest and most vulnerable Americans and their hearings needs.

You say in your testimony that that can still be achieved at reasonable cost to homebuyers, and I wonder what your notions of reasonable cost are and whether or not—whether we are talking about five basis points, and have you looked at whether you are going to really lock out a large section of potential individuals that need the assistance through that so-called reasonable cost?

Mr. GLAUBER. Mr. Kennedy, this is a discussion you and I had a year ago when I was testifying on this issue. And what I would like to say again to you is that I don't believe that we have to make a choice.

I really don't believe that safety and soundness has to come at the cost of these institutions meeting their mission to homeowners, that we really can have it both ways.

And let me tell you why. It should be possible for these institutions to raise significant amounts of capital and do so without raising their prices.

What it would mean would be somewhat of a reduction in the rate of return that they make.

Fannie Mae's rate of return on equity today is about 35 percent, maybe a little bit less, 33 percent. It could go down some and still be high enough that I don't believe that institutions would have difficulty in raising capital from the marketplace .

So I don't think that raising more capital has to come at the expense of homeowners who want to use the services of these institutions.

Mr. KENNEDY. I think you raise a really good point, and whether one of the reasons why the capital markets have been so friendly to this organization is because of the return that you have indicated, and that they are very forgiving in terms of the capital standards because of the quick return that they provide.

And I also wonder whether—you know, you have used phrases, Bob, indicating there aren't other competitors.

I am sorry, I didn't catch how you pronounce your name, sir.

Mr. WEICHER. Weicher.

Mr. KENNEDY. Mr. Weicher has talked about the fact that they are subsidized, talked about specific privileges. Under natural circumstances we would say, listen, let's let the boards of directors set the salaries of the individuals who work at these organizations.

But fundamentally, that isn't a real reflection because this isn't a market-oriented stock. This is not just determined based on how they do in the competitive marketplace.

This is an organization that is truly subsidized to some degree or another by the Federal Government, and it just seems that if what you are doing is allowing these individuals, who work in these organizations, very high salaries to begin with, many of them are based on stock performances, which would lead them to these high rates of return that you are talking about, leading the organization away from the mission that I think the Congress approves, that they are rewarded, in fact, for almost getting away from the mission and almost returning—becoming much more of an interest in the stock performance than they are in the performance of not only the mission, but really the purpose of safety and soundness.

And so it does seem to me that the compensation packages are, in fact, linked to safety and soundness.

And I wonder—I mean, if you have looked at them, there are many people—everybody knows about the $27 million Maxwell package. But the fact is that there are literally many people at the top echelons of these companies, organizations, I should say, that are earning millions of dollars a year.

They receive $400,000 to $500,000 dollars a year for life without any performance designation. They receive very large bonuses. I just read yesterday something about the fact that the new fellow—the new package at Freddie indicates that the bonus alone can be up to 120 percent of the annual salary, which went up $180,000 last year.

It just seems that we are really allowing these organizations to get away from the basic principles and that the salaries themselves

tend to feed just the kind of button that can be pushed to allow high rates of return which jack up stock prices, which end up putting the taxpayer at greater risk.

I wonder what your comments are.

Mr. GLAUBER. Well, Mr. Kennedy, I think most observers would agree that these institutions have done a good job, and I guess the question you are raising is at what price.

I would just echo some of the comments you made and the Chairman made earlier that summarily we look to a marketplace to act as a restraint of discipline on prices charged, on compensation levels set.

And to some extent here they do, although as you pointed out, because of the peculiarities of the marketplace and the dominance of these two institutions, it perhaps is a less severe restriction.

Mr. KENNEDY. Do you have a comment, Mr. Weicher?

Mr. WEICHER. No, no, Mr. Kennedy. I think the institutions do have opportunities to make high rates of return, given their special privileges as established in the charter acts.

I think that with respect to the compensation for their employees, in that market, they have to compete with other firms.

Mr. KENNEDY. There is no question that they have to compete with other firms. The question is whether their compensation packages are inordinately high.

Are you saying to me that you don't think a fellow earning $27 million last year was inordinately highly paid?

Mr. WEICHER. No. I am not addressing the specifics of it.

Mr. KENNEDY. Well, I am addressing the specifics of it.

Mr. WEICHER. Well, we do not have the authority——

Mr. KENNEDY. I think you ought to be addressing it. You are the regulator. You ought to be addressing the specifics.

Mr. WEICHER. We have no authority under the charter act to be concerned with the compensation.

Mr. KENNEDY. If you have no authority to look at compensation, it seems to me it is time to look at a new regulator.

Mr. WEICHER. That applies under the charter act. Whoever the regulator would be would not have that authority.

Mr. KENNEDY. We ought to look at the charter act, I suppose.

Thank you, Mr. Chairman.

Chairman GONZALEZ. Will you yield to me, Mr. Kennedy?

Mr. KENNEDY. Certainly, Mr. Chairman.

Chairman GONZALEZ. We kind of address that in H.R. 2900. You might take a look at it.

Mr. KENNEDY. I have looked at it very closely, Mr. Chairman, and I don't believe that it was done in such a fashion as to cap the salaries in a reasonable way.

The fact is that all of the—it would appear on the surface as having done so, but it leaves loopholes such as the bonuses, the stock options, the dividends, the performance bonds, and the pensions that allow each of these individuals to go out and make sometimes triple what would appear to be their salaries on the surface, Mr. Chairman.

Chairman GONZALEZ. Well, then, may I suggest that the gentleman prepare an adequate amendment. We have got that power.

That is what we are supposed to do here. We set the policy. This is the first chance we have had in drafting this bill.

I would suggest to the gentleman that he prepare an amendment.

Mr. KENNEDY. Thank you, Mr. Chairman.

Chairman GONZALEZ. We don't have to change regulators to do that.

Mr. KENNEDY. Thank you, Mr. Chairman.

Chairman GONZALEZ. Oh, you are ready, Mrs. Roukema?

Mrs. ROUKEMA. Thank you, Mr. Chairman.

I don't know whether we are going to get any light on this subject, but I would like to go back to the subject of capital levels.

And really it is a follow-up to the problem that Mr. Wiley outlined in that and to some degree, Mr. Baker alluded to with respect to the stress test, but it is the question of capital standards and the unfettered power of the regulator, which is what I understand Treasury really wants to have here, that the regulator would have total discretion here.

I am going to give you a chance to answer the question because I am not quite sure what any of us are talking about here.

You know, because of my introductory statement, because of my experience on the Banking Committee, you know, I favor higher capital standards and rather strict standards.

So let me ask the question this way so as to take it out of the theoretical about floors and ceilings and what regulators have latitude to do and what they don't have latitude to do.

As I understand it, HUD is about to adopt regulations, at least they have put them out, put forward some regulations. And within 1½ months, those regulations are going to go into effect, and they—as I understand it also, they are operating under a model that I believe Treasury would like to see, that is the authority is up to the regulator to forward these regulations.

And in the regulations, you have a stress test; is that correct? In the test you use the end of the year 1990 numbers, as I understand it.

I wanted to ask you specifically, using the stress test and the 1990 numbers, how big is the cushion between minimum capital and risk-based capital and I guess it is how much is enough for this cushion?

We in the bill have a certain number. I am not sure about that number, how valid it is. But Treasury, as I understand it, is refusing to give us parameters within which to work.

In any case, I would like both Mr. Weicher and Mr. Glauber to address the question in that frame and maybe we can get to something that is less theoretical and more specific.

Mr. WEICHER. Mrs. Roukema, with respect to the regulations, we are—we have sent proposed regulations. When issued, they would be proposed for comment.

Mrs. ROUKEMA. Those are the regulations I am referring to.

Mr. WEICHER. In those regulations capital standards are set within the terms of the charter act. We are proposing to look at the capital with respect to the risk of the different lines of activities that the GSE's are engaged in.

But with respect to formally establishing stress tests as the basis for establishing a capital standard that is more than what is in the charter act, we are talking about using the stress tests in the way that Mr. Glauber has been talking about, and we discussed in our testimony, and that would be under the new law.

Mrs. ROUKEMA. But what is the cushion? The question is, using the capital standards you have used, what is the cushion? How big is the cushion?

Mr. WEICHER. We have not—the capital standards in the existing law are set only in terms of standards against the debt of the GSEs. The debt applies only—is needed only for the mortgages that are held in portfolio, so the capital standard as specified in the law is the capital standard against mortgages.

It is not set against securities. This is one of the problems with the capital standard under the present charter acts, one of the problems that the administration's proposal is intended to fix.

Mrs. ROUKEMA. I would ask Mr. Glauber to use that, to perhaps fix his own position.

Are you telling me that under the stress test you have not set a cushion figure?

Mr. WEICHER. We are in the process of conducting stress tests now, and we intend to be reporting to you on the results of stress tests in the next few weeks.

We have not established a capital standard with a stress test under the regulations .

Mrs. ROUKEMA. But I don't understand, then, why you cannot—but you can, using those numbers, and using their methodology, define—you will come up with the cushion, no?

Mr. WEICHER. We will come up with a measure of the capital that each GSE needs in order to pass a given stress test.

That can be then compared to the capital that they have, and this is what we are now doing. This goes back to a point Mr. Glauber raised earlier. We don't have specific numbers here to give you.

Mrs. ROUKEMA. Mr. Glauber, would you allude to that? I mean, would you amplify from your perspective, and then using that rationale that how do you know what we have in the bill is too weak?

Mr. GLAUBER. Let me start with something Mr. Weicher said. The regulations, currently permit law, deal only with—on-balance sheet debt, not with pass-throughs, not with off-balance sheet guaranteed mortgage-backed securities, called pass-throughs.

That is precisely one of the problems we have with writing these things into law.

The world changes, and you will wish after you wrote the law that you had written it differently. This is a perfect example of that problem.

Second, halfway through your statement you saw me shaking my head. I don't think that we want to give unfettered freedom to the regulator.

We are sensitive to your concern that our regulator could run amuck. So perhaps the way to do it is to allow the regulator discretion flexibility within some range, to put a minimum, put a maximum.

Now, you said can we be specific. Let me start by being specific. We think that the minimums set in H.R. 2900 are too low. They

are lower than what we proposed. For Freddie Mac I think they are lower by $250 million. We think they are too low.

We would like to see as a starter that the minimum be raised to what we proposed. Over that we say for setting what is called adequate capital, we would like some discretion, giving the regulator discretion is not, you know, uncharted waters.

In the bill you voted out of committee, the banking bill, you give the regulator discretion for setting where zone 1 ends and where zone 1 begins. You give the regulator discretion in setting that. So this is not something new.

The question is how much discretion should you give. I agree with you, you shouldn't give them complete discretion. It should be limited.

Let's work on how to limit it but still give them enough discretion.

Mrs. ROUKEMA. Can we work together on that?

Mr. GLAUBER. I would be more than happy to do so.

Mrs. ROUKEMA. I don't know why this has become such an issue that it has forced people to lock horns or we cannot seem to get the issue resolved.

All right, thank you.

Mr. GLAUBER. Absolutely.

Mrs. ROUKEMA. I think that has been helpful. I hope it has been helpful to all of us, and we certainly will accept your offer and continue to work on the problem.

Mr. GLAUBER. I look forward to it.

Chairman GONZALEZ. Mr. Johnson.

Mr. JOHNSON OF TEXAS. I would like to follow up on Ms. Oakar's comments about who is regulating. Assuming we can get over the argument of capital requirements and that everybody can agree on them, can you talk to the safety and soundness regulator, and are you comfortable with it being in HUD, or could it be somewhere else besides HUD, maybe in the Treasury?

Mr. GLAUBER. Oh, it could be indeed somewhere else. We are quite comfortable. We think HUD has the expertise in the field.

What we do think, that the safety and soundness regulators should be arm's length, and we think the structure we propose and indeed is embodied in H.R. 2900 is an appropriate structure.

We recognize there could be other structures as well, but we liked what we proposed; and we are happy that the subcommittee has embodied it in H.R. 2900.

Mr. JOHNSON OF TEXAS. I appreciate that. Let me follow up on Mrs. Roukema's suggestion on capital.

I think her question was—and I never did hear you answer, is why do you think that the number that is in the bill is not right?

Mr. GLAUBER. Well, as regards the minimum capital standard, we think it is not right because it allows—it designates—that these institutions today exceed the minimum standard, and most observers think that they need more capital before they meet a minimum standard.

So I guess that is the short answer to why we don't think minimum is enough.

Mr. JOHNSON OF TEXAS. Well, most observers is who?

Mr. GLAUBER. GAO, CBO, us, HUD.

Mr. JOHNSON OF TEXAS. But not the subcommittee?

Chairman GONZALEZ. Many observers.

Mr. Johnson, will you yield?

Mr. JOHNSON OF TEXAS. Certainly.

Chairman GONZALEZ. GAO tells us both organizations are currently adequately capitalized. That is their report. See, this is the dilemma I hear. But thank you for yielding.

Mr. JOHNSON OF TEXAS. Thank you, sir, and thank you for your response.

Mr. GLAUBER. Let me finish by saying the other concern is not with a specific number but again with the process, and this exclusive reliance on a stress test and a specific period of history in that stress test.

Mr. JOHNSON OF TEXAS. OK. Thank you.

Thank you, Mr. Chairman.

Mr. WYLIE. If the gentleman would yield.

Mr. JOHNSON OF TEXAS. Certainly, Mr. Wylie. I have some time left.

Mr. WYLIE. GAO says they can be both adequately capitalized. In your testimony, I note, Mr. Glauber, you say Fannie and Freddie Mac's own internal estimates of their earnings and capital levels over the next 3 years indicate they will have no difficulty in meeting through retained earning the administration's critical capital level minimum leverage ratio and any reasonable risk based capital level, close quote.

Now, Fannie and Freddie say your capital standards are too high. Could you provide the subcommittee with the so-called internal estimates that you used which may indicate why or why not they are objecting?

Mr. GLAUBER. We would be happy if we could. They were provided to us under confidentiality agreements which were specified in FIRREA. I think we are not in a position to supply those directly to you. Perhaps you would like to take it up directly with Fannie Mae and Freddie Mac.

Mr. WYLIE. So we need to have it released from them?

Mr. GLAUBER. We were required to return all that information to them because it was given to us under a confidentiality agreement, as specified in FIRREA, and have done so.

Mr. WYLIE. Thank you.

Chairman GONZALEZ. Well, thank you very much. I am going to ask my colleagues to indulge me for 1 minute so that I can address a question here and not expect it to be answered except in writing rather than wait until I submit it in writing because—to Mr. Weicher.

We didn't intend to clobber Mr. Glauber, and that is what we have ended up doing, and we have ignored not intentionally Mr. Weicher.

Mr. Weicher, from your description of how HUD might run the stress test in H.R. 2900, it sounds like you would have lots of discretion with respect to the application of that test.

What additional discretion are you seeking? Would you rather use Moody's test than the one in H.R. 2900?

In your testimony, you state that the amount of capital for operations and management risk should be left to the regulator.

It is, and that was, the intent of our legislation. I wanted to make sure that if we were deficient in any way defining that in the legislation, we would want to know. We thought that is what we were doing, and how would you change the statutory language to clarify this particular authority if clarification is needed?

Mr. WEICHER. Mr. Chairman, I would be glad to answer all those questions for you. If we have misread the bill, which, of course we have only seen over the last couple days, we would be glad to provide you with revised views.

[The information referred to can be found in the appendix.]

Chairman GONZALEZ. I am fully aware of the fact that both of you came here with the fact that the bill was introduced Tuesday, so thank you gentlemen once again very much.

We appreciate your cooperation.

Mr. GLAUBER. Thank you for having us.

Chairman GONZALEZ. The next panel consists of Mr. Leland C. Brendsel, Chairman and Chief Executive Officer of the Federal Home Loan Mortgage Corporation and Mr. James A. Johnson, Chairman and Chief Executive Office of the Federal National Mortgage Association.

Mr. Johnson, while we wait for Mr. Brendsel, he was, of course, here earlier, why don't we proceed and recognize you. I saw you sitting there and wincing a couple of times, and I think you know now how some of us in politics feel when somebody, a commentator or some citizen is commenting about us.

Mr. JAMES JOHNSON. I hope I wasn't shaking my head too vigorously.

Chairman GONZALEZ. Thank you for your statement. We are also cognizant of the fact that we just introduced H.R. 2900, but I think you may have had the benefit of the main thrust of that bill before its introduction.

In any event, suppose we recognize you, and then advise that your testimony as you gave it to us in writing will be in the record exactly as you gave it to us. You may proceed as you deem best.

STATEMENT OF JAMES A. JOHNSON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION

Mr. JAMES JOHNSON. Thank you very much, Mr. Chairman.

I appreciate the opportunity to appear before you again this morning to discuss the best way to modernize the capital requirements in oversight of Fannie Mae to protect the taxpayers while maintaining and further enhancing Fannie Mae's ability to serve housing.

I most particularly appreciate the opportunity to congratulate you on the introduction of H.R. 2900, your thoughtful and well-crafted proposal, cosponsored by Mrs. Roukema and Mr. Wylie.

H.R. 2900 is an outstanding contribution, in my judgment, in a number of respects. First, it would establish for Fannie Mae and Freddie Mac a risk-based capital standard that is the most modern, most progressive, and most analytically correct standard in any legislative or regulatory capital regime.

Second, by specifying the parameters of that standard, the bill takes a stand and a firm stand and makes that absolutely critical policy decision of just how risk and housing should be balanced, which, after all, is what this exercise is all about.

Finally, the bill sets in place a regulatory oversight, supervision, and enforcement approach that is strong yet sensible, and generally reinforces the genius of Congress' 1969 decision to make Fannie Mae a private company with private market management and incentives.

We are very pleased with many of the key provisions of the proposed legislation. When I last appeared before you in late May, Treasury has just delivered its draft bill. I described to you at that time my concerns with that bill. I am very pleased that many of the specific issues we raised at that time have been creatively and effectively addressed in H.R. 2900.

In 4 years in particular H.R. 2900 is a vast improvement over the Treasury draft. The first I have already mentioned. Instead of the open-ended regulatory discretion of the Treasury bill, H.R. 2900 establishes a specific capital standard.

Second, the risk-based capital standard in H.R. 2900 is a complete and specific stress test, not simply a list of risks that the company must capitalize for, as in the Treasury bill. The test is dynamic. It will be a leading indicator of potential problems.

For example, if interest rates rise in a quarter, the interest rate requirement will be recalculated and more capital will be required. The same is true if rates fall. If the increase in home prices slows down, more capital will be required for credit risk if the company takes more credit risk by, for example, increasing its duration gap, more capital would be required.

If riskier loans are purchased, more capital would also be required. Third, H.R. 2900 provides for appropriate regulatory structure. Professional and competent oversight is essential if both taxpayers and housing are to benefit. Unlike the Treasury bill, H.R. 2900 makes this a real point by authorizing hiring outside civil service limits.

Fourth, the supervisory and enforcement powers in H.R. 2900 are specifically geared to the nature, scope, and unique position of Fannie Mae and Freddie Mac, and unlike the Treasury bill, are not simply a cut and paste version of Treasury's bank reform proposal.

Within the context of this very favorable reaction, I want to call the attention of the subcommittee to 4 areas that do cause us concern at Fannie Mae. First, section 201(a)3, which gives the capital regulator open-ended discretion to increase the capital requirement for management and operations risk over and above that already embedded and interest rate risk tests; Second, sections 3(6), 121(f), 121(k), and 201(a)4, which, combined, could have a paralyzing effect on product innovation, even by a well-capitalized company; third, section 121(k), which by targeting a percentage of dividends for the purpose of making contributions to low-income rental housing, could reduce Fannie Mae's effectiveness in the multifamily housing area, as well as undermine investor confidence; and, four, section 121(e), which would destroy the ability of Fannie Mae's board of directors to recruit and retain the best managers for one of the largest financial institutions in the world.

We strongly urge the subcommittee to delete the clause section 201(a)3 that would allow the Director to increase or decrease the management and operations risk requirement from the requirement at 20-percent of interest rate and capital risk, about $800 million currently for Fannie Mae, which is stated in the bill.

This open-ended discretion undermines the uncertainty of the credit and interest rate risk stress tests and is a serious mistake for three reasens.

The amount in the bill is more than enough to cover the type of management risks it is possible to capitalize against. Two, if the risk-based capital level is left open-ended, Fannie Mae will have great difficulty managing our business so we can meet both our responsibilities to housing and our capital requirements, and, three, it allows the regulator to undercut the choices that have been made on capital levels in the credit and interest rate sections.

Our second area of concern rises out of two provisions that would require prior approval by two different parts of HUD with conflicting mandates before Fannie Mae could undertake any new product or program.

Moreover, those provisions interact with a third, under which the Secretary would be required to require a portion of Fannie Mae's business to be for low- and moderate-income housing in a manner that could lead to total paralysis.

To maintain Fannie Mae as a strong, innovative, flexible private market provider of housing finance for all, these well-intentioned provision must be modified. They are unnecessary, I think, for a properly capitalized company.

Section 121(k) of the bill would require that 20 percent of Fannie Mae's dividend payments are contributed for acquisition, construction, and rehabilitation of low-income rental housing. Fannie Mae wholeheartedly supports in both word and deed the goal of doing more for low-income rental housing.

As drafted, however, this provision is a serious mistake, and in our opinion should be deleted. We currently serve over 1 million families in multifamily housing under our standard and FHA programs. In 1990 alone, we financed over 104,000 rental units. Approximately 80 percent of the households served through that multifamily program have incomes below 80 percent of the median for their area.

In some places, Baltimore for one, the average unit is affordable to those with less than 50 percent of the median income. These are the types of programs in which Fannie Mae excels, the types of programs that use our strength to tap the capital markets to help those in greatest needs.

We are now focused on expanding our effort further to serve those with greatest needs by making investments to support low-income housing on terms that could not be accommodated under standard programs or even our special low- and moderate income programs, such as gap financing and pre-development capital.

We will be able to expand our reach to even more low-income tenants. Section 121(k) of the bill, with the 20-percent contribution requirement for low-income rental housing not only would put Fannie Mae in the subsidy rather than in the financing business,

but by penalizing shareholders would harm our ability to serve the entire housing market.

I don't think that is the best way to get the best from Fannie Mae and Freddie Mac. Finally, I believe it is essential that section 121(e) of the bill be substantially amended.

As drafted, that section would limit compensation for Fannie Mae management to that of Freddie Mac management as of July 1, 1991. This provision would totally undercut the Fannie Mae board of directors' ability to attract and retain the best people to run a $400 billion company safely and profitably while accomplishing our housing mission.

The Fannie Mae Board of Directors has long-followed the principles of comparability of pay with payment for similar functions at similar corporations, pay for performance, and no pay for nonperformance.

Mr. Chairman, in May I was able to bring you up to date on both Fannie Mae's sound financial condition and our impact on housing for those all across the income spectrum. Since that time, we reported our 14th quarter of record earnings. Capital reached $5.6 billion, including $650 million of loan loss reserves, meaning that for the first time we meet the taxpayer protection capital standards we have developed for ourselves with Paul Volcker announced well over a year ago.

We announced our intention to purchase up to $2 billion in FHA insured reverse annuity mortgages, serving 25,000 elderly households, and a $100 million demonstration program in partnership with the Farmers Home Administration to make mortgage credit more available to low- and moderate-income households in rural areas.

Our standard business has reached record volumes. In the first 6 months of the year, we purchased more than $16 billion of mortgages and securitized an additional $45 billion for a total business volume of $61 billion during the first half of this year.

Fannie Mae is working very well for housing and for the American people. H.R. 2900 is a major contribution to making certain that Fannie Mae continues this record of success. We look forward to working with you, Mr. Chairman, and the rest of the subcommittee to make it even better.

Thank you very much for your attention.

[The prepared statement of Mr. James A. Johnson can be found in the appendix.]

Chairman GONZALEZ. Thank you very much.

Mr. Brendsel.

STATEMENT OF LELAND C. BRENDSEL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF THE FEDERAL HOME LOAN MORTGAGE CORPORATION

Mr. BRENDSEL. Thank you, Mr. Chairman, and thank you for the opportunity to discuss H.R. 2900. I would like to commend you, Mr. Chairman, and Representatives Wylie and Roukema for introducing an innovative bill, one that recognizes the unique characteristics and risks of Freddie Mac and Fannie Mae.

It is fitting that you should sponsor this hallmark approach to regulation, for you also were present at the creation of Freddie Mac nearly 21 years ago. We are a great congressional success story, one for which you and your subcommittee deserve special credit.

It is a story about a rare public-private partnership that works, and it works without taxpayer funds. Indeed, we paid over $1 billion in Federal income taxes over the past 4 years.

Also, it works because, as all studies indicate, we do so without any meaningful risk to taxpayers. But most importantly, this public-private partnership has meant that we have helped provide affordable housing to millions of Americans across this Nation, in small communities as well as large.

Mr. BRENDSEL. Your legislation reflects the conclusion of seven studies by five government agencies, including the Department of Treasury conclusion that Freddie Mac is well-managed, financially sound, and presents no imminent threat to the taxpayer.

Indeed, Secretary Glauber has said before Congress this year, that the current risk to the taxpayer is de minimis. Freddie Mac opened its books to all of these agencies studying us, and we received a clean bill of health.

My perspective is if bank and thrift institutions, or certainly their insurance funds, had opened their books to the scrutiny of five independent government agencies, I wonder if the taxpayer would have more money in their pockets today?

Your legislation incorporates state-of-the-art tools to ensure Freddie Mac's and Fannie Mae's continued sound operations.

Let me give you three examples. First, your inclusion of market-to-market accounting to monitor the financial condition of Freddie Mac and Fannie Mae. Nowhere else in financial regulation do we have this done today.

A second innovative approach for the first time specifies capital requirements to cover interest rates. It has been over 10 years since sky-rocketing interest rates nearly wrecked the thrift industry, and yet the Treasury itself has yet to seriously recommend capital requirements to reflect adjustments in interest rates for other financial institutions.

Third, an innovative approach here is that it uses dynamic capital requirements, one which incorporates real-world experience such as Texas in the early 1980's, rather than simple ratios pulled out of the thin air.

To put your legislation in perspective, if these same capital tests were applied to a typical thrift or bank holding a portfolio of primarily fixed rate residential mortgages, they would have to hold twice the amount of capital currently required under the Treasury's own risk-based capital standards.

These are indeed tough capital standards embodied in this legislation. Clearly, your approach of measuring capital is light years ahead of existing regulations covering other institutions in this area.

Before commenting further on your proposal, let me make a couple observations. First, Treasury's proposal is a black box. Neither you nor the taxpayer know what it really means, or if it could be effectively implemented.

Second, Treasury's proposal also fails because it proposes to utilize arbitrarily high minimum leverage ratios.

Third, Treasury's proposal includes broad powers for the regulator to unjustifiably intrude in the day-to-day operations of two well-capitalized entities. Certainly, the myth that government regulators know best was exploded during the past decade.

As I indicated, Mr. Chairman, your legislation is an impressive leap forward. It puts you in the forefront of financial institution regulation. At the same time, I have several suggestions about how it can be improved.

I will discuss only a few key suggestions here today, and am happy to share additional thoughts with you and your staff in the future.

First, with regard to setting capital requirements. This legislation, H.R. 2900, requires that an additional amount of capital equal to 20 percent of the requirement for interest rate and credit risk be held to cover management and operations risk.

Twenty percent is too high, frankly, given the very tough capital requirements for interest rate and credit risk. Even worse, the regulator would have the authority to go above the 20-percent requirement without any justification, leaving us exposed to the vagaries and arbitrariness and the black box of regulation. Such discretion is unwarranted.

Second, with regard to other regulatory discretion, in the area of new products, for example, the proposal incorporates a very cumbersome system of bureaucratic involvement in new program and products.

I believe as long as we are adequately capitalized, there should be no preapproval authority for the regulator to intervene in the business decisions, as long as we meet our capital standards.

Also, in particular, the proposal overrides the ability of our Board of Directors to attract the best people by preventing us from offering market base compensation. There is no substitute for good people, as I am sure we all agree. Tying our hands in this area could prove to be very expensive and costly in the long run to our safety and soundness, and to achieving the missions of the company.

A third area of suggestions is with regard to examinations and assessments. Good regulations require good people to enforce them as well. The proposal, I think, unnecessarily restricts the Director from using the most competent personnel for its oversight of Freddie Mac and Fannie Mae.

I believe the regulators should be encouraged to draw on the resources of experienced, professional examiners elsewhere in the financial regulatory system such as those of the Federal Reserve Board of New York.

Also, I believe it is appropriate that Freddie Mac should pay for these examinations. However, any assessments should be capped to cover only the cost associated with the regulation and examination to prevent the unnecessary growth of a new regulatory bureaucracy.

Now, a fourth area of suggestionsis with regard to the low-income rental housing provisions. Freddie Mac's 20-year history provides a proud record of assisting many Americans in their pur-

suit of affordable housing. The availability of capital in all markets has significantly enhanced the home ownership and rental opportunities for all in this country.

Our long-standing commitment to this mission results in a mortgage market that works today, when other sectors have experienced credit shortages. I know you are aware of our successes of our standard programs, but they should not overshadow our special commitment, also, to low- and moderate-income housing.

For example, we have committed $3 billion through 1992 alone to invest in special low- and middle-income programs.

Freddie Mac is strongly committed to its mission of financing affordable housing and I think our record demonstrates that. From that vein, I am concerned with a few sections in the rental housing program section of this bill.

The first is the requirement that Freddie Mac set aside an amount equal to 20 percent of its dividend payments to rental housing fund. This is, in effect, another tax and results in a triple tax on the dividend payments of Freddie Mac.

We rely on funds raised in the capital markets to provide mortgage financing opportunities to homebuyers and renters nationwide. We rely on the confidence of investors in our mortgage-backed securities, as well as our stockholders.

The approach taken in this legislation could jeopardize the confidence of investors and threaten our ability to access the capital markets and accomplish our mission. I believe the provision in this proposal ultimately will not maximize the benefits we can bring to low- and middle-income housing.

The second feature of the legislation in this area would significantly alter the public-private balance by allowing HUD to micromanage our pricing decisions. Simply at the implementation level, I believe it is unworkable to allow the Secretary of HUD to review all the pricing decisions of Freddie Mac since we change prices every day.

Mr. Chairman, in conclusion, I have outlined a few areas of suggestions. However, I want also to reemphasize that your legislative proposal is a major step forward in creating a state-of-the-art, sophisticated regulatory approach with an equally innovative Freddie Mac and Fannie Mae.

In this way, we can ensure a continuation of our great story as a continuous source of private capital, financing a great public mission.

Mr. Chairman, I would be pleased to answer any questions you or any other member of the subcommittee may have.

[The prepared statement of Mr. Brendsel can be found in the appendix.]

Chairman GONZALEZ. Well, first, let me thank you and Chairman Johnson for your very kind remarks.

I think, as I said earlier to the two previous witnesses, we basically want to achieve the same goal, and I think your statements and recommendations have been both constructive and very helpful.

I think you have pointed out some things that will cause us to pause and look over. Now, specifically to both of the witnesses, I wonder if you can comment on the Treasury's assertion that re-

quiring you to raise additional capital would have no effect on market rates.

I think the question there is, how would you raise additional capital?

Mr. JAMES JOHNSON. Would you like me to start, Mr. Chairman?

Chairman GONZALEZ. Yes, sir.

Mr. JAMES JOHNSON. When we were here on May 29, we talked specifically about the relationship between the fees we charged and the mortgage rates that individual mortgage payers would have to pay. Treasury's point seems to have to do with the ability of the organizations themselves to absorb substantially lower returns on equities and still be able to attract the kind of investment that they attract today.

Obviously, this entire system works, because we are able to attract very high levels of private investment. If you look at Fannie Mae's return on equity—this is certainly not what shareholders get, this is the return on equity in the company, Fannie Mae's return on equity over the last 5 years has been approximately 24 percent.

If you look at the 50 largest companies in America, they have exactly the same return on equity during that time period. One is 24.4 and one is 24.6 percent. So, if you are an investor and you are trying to choose which company you will invest in, you want to invest in one that is competitive with with the general return of large companies, similar to Fannie Mae and Freddie Mac.

We don't accept the Treasury assertion that we could have a rapid decrease in our return of equity and still attract shareholder investment the way we do today. We think that is a misperception of the way the market would be likely to work.

Now, return on equity is something that changes a good deal as your know from considering a lot of banks and thrifts over the last few years. Sometimes it is high, sometimes it is low.

If you look at the range for those top 50 companies, the range is from zero to 37 percent. It is not that they are all exactly hovered in the middle. That will change for us, too. It is already changing for us.

Our return on equities have gone down rather substantially as we increased our capital. We are continuing to increase our capital at quite a rapid rate. I think the Treasury believes that there is a great deal more flexibility and give in this system than there is, and I think over time, it will be critically important that we achieve a strong return on equity to continue to attract private investment.

So I don't believe they have calculated the relationship between the investor concerns and the need for capital properly.

Chairman GONZALEZ. Mr. Brendsel, do you have any comment?

Mr. BRENDSEL. Probably the simplest and most direct way to respond to a comment like that by the Treasury is to remind Treasury that there is no free lunch. In essence, these companies work because we are able to attract capital and maintain the confidence of investors, and we do so by operating in a safe and sound way and providing a fair competitive return on their money.

Certainly to the extent that the company continues to grow and invest additional capital, we must pay shareholders a fair return

on their money. And as a result, any increase in capital requirements that is excessive—since clearly we have already demonstrated through these studies that any increase above the current levels that the companies maintain in relation to the risk would be a tax on shareholders—would be unwarranted.

Chairman GONZALEZ. I am going to make a couple of observations. We have a notice call of a recorded vote, but we will leave in a few minutes.

You did, I think, make a valid point with respect to the conservatorship in a dire case, and the conservator being RTC. In your statement, Mr. Johnson, you point out you have $45 billion in securities.

Mr. JAMES JOHNSON. Mortgage-backed securities.

Chairman GONZALEZ. I noticed that RTC has decided to go that route, and interestingly went to the international market. And being that RTC has such a substantial REO or portfolio out there, how do you see that as a sort of a hidden liability as to potential mischief in the future?

Mr. JAMES JOHNSON. The key to the Fannie Mae and Freddie Mac mortgage-backed securities program is the underlying quality of the asset. That is what makes the difference in all of the mortgages we sell to the marketplace or we securitize for the marketplace. That is because of the underwriting standards we have, we have very, very few losses on the mortgages that are in the securities that are issued through Fannie Mae and Freddie Mac.

As a matter of fact, what we do in those securities, Mr. Chairman, is guarantee the timely payment of principal and interest on those mortgages so that we are responsible for the ones that we put in the mortgage-backed securities. That is one of the reasons why risk-based capital standards are appropriate for Fannie mae and Freddie Mac and that is our experience with the risks that we take has been extraordinarily good.

In terms of what the RTC is doing with their direct issuance of mortgage-backed securities, they have just started that program. They are in some cases dealing with products we would not deal with that we would not find suitable to securitize through Fannie Mae and Freddie Mac. I think we are all watching closely how that will evolve.

If the underlying mortgages they are selling are strong and similar to the ones that are part of the Fannie Mae and Freddie Mac mortgage-backed securities, I believe their program will go very well.

The problem the RTC has had over the last several years—I testified before Congressman Vento specifically with the RTC Task Force on this point. They have had substantial documentation problems on a lot of those mortgages and originally the RTC was unwilling to follow market practice and provide buyers with loan representations and warranties.

Chairman GONZALEZ. We must go and afford the Members a chance to vote.

Mr. VENTO. Mr. Chairman, if you would yield to me briefly, this testimony from the Fannie Mae and others came well over a year ago. Furthermore, I wonder what the capital standards are that

the RTC has in terms of what they are doing. Obviously they have got us behind them.

Chairman GONZALEZ. I think there—Mr. Vento, if you would yield to me, I think the disturbing factor is that you have a constantly decreasing value, deteriorating value in all of those assets and in fact the Secretary, the chairman of RTC reported just over the weekend that that loss was in the range of 40 percent.

Anyway, we better go vote.

[Recess.]

Ms. OAKAR [presiding]. The subcommittee will come to order.

The chairman has asked if I would proceed. He is on his way back, but he has asked to have me proceed. And Mr. Wylie was next in questions. He is not here, so I will turn to Mr. Leach.

Mr. LEACH. Thank you,

Well, Madame Chair, first, let me say that I think the U.S. Congress, as well as the public at large, can consider themselves very fortunate that we have two people running these institutions that are as able as they are.

Mr. Brendsel and Mr. Johnson, I think that is clear-cut. From our perspective, we must ask a given number of questions, and from your perspective, you must take a different position?

For example, I just cannot see for the life of me anything wrong with pressing for higher capital, although if you run an institution, you prefer to leverage as much as you can, and that is extraordinarily understandable.

We have two different approaches to capital. The administration suggests a little stronger approach, the subcommittee approach is a little weaker. I give my benefit of the doubt as a representative of the taxpayer to higher ones. I can understand where the two of you want to represent your stockholders and want a little greater leverage.

I want to say that is a difference of perspective, but it is almost inevitable. Yes, sir.

Mr. JAMES JOHNSON. Could I respond to that?

Mr. LEACH. Yes, sir.

Mr. JAMES JOHNSON. Let me make two quick points. I didn't mean to interrupt your statement by any means. Fannie Mae has by no means taken a position that less capital is better. As a matter of fact, in 1990 and 1991 we will add about $2.5 billion to our capital from earnings.

Mr. LEACH. That is wonderful.

Mr. JAMES JOHNSON. May I make a second point? That is that one of the problems that we have in this entire discussion—and I am sorry that Mr. Wylie and others aren't here, Mrs. Roukema, to hear this particular exchange because I know it is something very much on their minds——

One of the problems, Congressman Leach, is that over the course of the last 2 years of Treasury and HUD taking a look at Fannie Mae and Freddie Mac, neither institution, neither Treasury nor HUD, has ever come forward with either a capital number or a capital approach that would allow us to compare either our internal approach with theirs or the subcommittee's approach with theirs.

What you say about there being a difference of opinion really is not a difference of opinion at the moment. Because from HUD and Treasury at the moment there has not been an opinion about what a proper level of capital should be.

I think what Secretary Glauber said this morning was quite significant. That is, he imagined a circumstance in which they would do the work on capital which would lead them to the position where they could say a number that would be too much. He has introduced the concept at some level there is too much capital.

I think if they were able to be forthcoming and say this is the range we are looking at that would be an enormous contribution to this debate. What is missing at the moment there is a committee position on adequate capital. There is a Fannie Mae position on adequate capital and Freddie Mac position on adequate capital, but there really isn't a Treasury position.

Mr. LEACH. I will make that a formal request from the Treasury.

Let me go on for a moment. I once talked to one of the gentlemen who created Freddie Mac. He indicated to me that Freddie Mac was intended as a government experiment to last 3 or 4 years and be spun off to the private sector. In your testimony, Mr. Brendsel, you indicate that there is a nice marriage between public and private. Why not go completely private, or, if it is such a nice marriage, why don't we have instead of just the two relatively similar institutions, why don't we have 10 or 12? How would you respond?

Mr. BRENDSEL. With regard to the second of the two suggestions, that certainly is a decision that Congress always can make since they are government-chartered corporations.

I would say that, in fact, there are many things to look at in the structure of GSEs that should be considered with regard to the structure of the financial system in general. Why have these companies worked so well? Well, there are some fundamental things about us.

First of all, we have a very well-defined charter restricting us to participate in the market inequality assets, residential home loans.

Mr. LEACH. I object to that. I don't think we are talking exactly to my question. Why don't you let me go on for a little bit more.

There has been a pretty lousy article written about you, and as I understand Freddie's position is it lacks validity. I saw something from Shearson—a good neutral investment bank—that holds your side of that argument. One of the aspects of your whole institution is that your reserve for losses appears to be fairly low. It is 0.12 percent. As I understand it, Citicorp's single family delinquency rate last year was 4.8 percent or at least at the end of March. Are you doing that much of a better job than Citicorp?

Mr. BRENDSEL. We are doing that much better job than Citicorp.

Mr. LEACH. As I understand it, Chase had 0.55 percent losses and looks like it hasn't done as well as it should, but you have done four times better than Chase and, according to this article, about 40 times better than Citicorp. Is that correct? In your loan losses?

Mr. BRENDSEL. Probably about right. Our loan losses relative to the amount of loans in our portfolio is .05 percent, five basis points on an annual basis. Significantly below the industry average.

Mr. LEACH. That is extremely impressive. One of the questions we have to ask ourselves is: Is the past a good gauge of the future,

and is it always relevant, especially as you change your mix in what you participate in? Do you think that gauge can be counted on in the future?

Mr. BRENDSEL. As long as Congress restricts our charter to purchase only investment quality residential mortgages it is a very good gauge for the future. Specifically, we have got a vast amount of data and experience on 6 to 7 million home loans across the nation.

Mr. LEACH. My impression is you have done a good job. It is also my impression that if we take the thrift issue as well as the banking issue across the country there has been a bit of a breakdown in the last half decade or so about borrower accountability to lending institutions. It looks as if losses are going up throughout the financial industry, but it hasn't applied to you, and I am impressed with that.

But as a legislator I have to say possibly it will come to apply to you. It appears people have been lying about their income and there are other sorts of circumstances.

Anyway, my time has expired. I just want to raise that. I am not sure one institution will always be going totally against the trend on asset quality. Maybe you can continue it, maybe you cannot. If you can't, you do need more capital.

Mr. BRENDSEL. First of all, we are not the only institution out there with excellent asset quality. Our friendly competitor sitting next to me has an outstanding performance on their portfolio as well.

The genius of H.R. 2900's capital standards is, in fact, that it is dynamic. It looks to experience. In fact, I think in previous conversations with you, Congressman, I have indicated that we have been employing stress test kind of analysis for evaluation for several years. We have used the Great Depression to analyze our portfolio. H.R. 2900 looks at the worst case since World War II.

We now have a lot of experience, for example, with the Texas loans. H.R. 2900 assumes that Texas, the experience there in the early 1980's, would occur nationwide, that in every community one out of four low downpayment mortgages would default. This presents serious credit risks and that is the amount of capital we would be required to support.

Ms. OAKAR. Mr. Leach's time has long expired. We do have other Members who have been here since 10 who want to ask questions. I would appreciate it if we can proceed and if the answers could be relatively short as well—just because some of the Members have to leave and they want to ask you questions, including myself.

Mr. BRENDSEL. I apologize.

Ms. OAKAR. Not at all.

I know Mr. Johnson wanted to respond. I will give you 1 minute to respond.

Mr. JAMES JOHNSON. Let me try to be very quick.

Congressman Leach, earlier in the session you talked about $2 billion to $4 billion subsidy that came to Fannie Mae and Freddie Mac. Let me just——

Ms. OAKAR. That was going to be my question so don't ask that on my time as a question.

Mr. Brendsel in his testimony indicated that this program does not cost the taxpayer anything, and Mr. Leach did mention the subsidy angle, and the Chairman indicated he was going to give you a chance to respond—you in the plural sense. Why don't you respond to that? Who is right? Is this a subsidized Federal housing program or is it more correct to say HUD is where the federally subsidized program is and you are in this quasi-government public/private partnership? Do you want to respond?

Mr. JAMES JOHNSON. This is certainly not a subsidized Federal housing program. In the course of the last 2 years of having everybody study us, one of the things that OMB and CBO focused on was the great efficiency with which Fannie Mae and Freddie Mac transferred what they interpreted to be the subsidy directly to homeowners. This is not a subsidy to Fannie Mae and Freddie Mac. This is not something that comes to us that we keep in anyway. This is a subsidy that is passed through to us homeowners all over America.

If you look in any paper you will see people whose mortgages are able to be purchased——

Mr. LEACH. Madam Chair, may I have 10 seconds to respond?

Ms. OAKAR. Sure.

Mr. LEACH. I basically agree with that, Mr. Johnson, with some exceptions. Twenty-seven million dollar severance pay is not a subsidy to a homeowner, and that is a scandal that your institution must bear, period. And I can sympathize with the wonderful——

Ms. OAKAR. Let me reclaim the time now because, really and truly, other Members have to go on.

I think your point has been made, but I personally was under the impression that when you talked about a Federal subsidy you were talking about Federal subsidy to the agency, and, obviously, that is not the case.

Let me ask a question now about salaries, because I think we should hit the issue head on. I did the amendments regarding FIRREA and salaries and making them comparable. I am also the author of the pay equity legislation which passed very overwhelmingly in the House and failed to pass in the Senate, but we are doing GAO studies on that issue.

In addition, many of us—some of us on this subcommittee—are very concerned about women and minorities being in top slots, particularly when it is a government sponsored program and founded by the government and the Congress.

Tell me about these top executives in terms of who is who. Can you give me any description of the women and minorities that are in the upper echelon? I really—I am concerned, obviously, about the clerks and typists and secretaries, and I think they—I hope their salaries are not undervalued because that is a very important—those are important positions and, frequently, they are undervalued. But, Mr. Johnson, would you tell us a little bit about the top people in Fannie Mae?

Mr. JAMES JOHNSON. I would be happy to. The top minority person in Fannie Mae is the vice chairman of the company. The top woman employee of Fannie Mae is the executive vice president, secretary and general counsel, Carol Bernstein. We have just received some very significant awards for the number of women who

have been put in very key management positions in Fannie Mae. You look at our entire top management group, between 250 and 300 people, about 34 percent of that group are made up of women.

We have a pretty good record as well—I think a quite good record as well with minorities. Thirty-seven percent of our overall work force is made up of minorities, and 14 percent of those minorities were promoted within the last year.

So, you know, we always have more to do in that arena, but I think both in terms of senior officers, other officers, management level employees, we have a pretty good record.

Ms. OAKAR. If I went over to Fannie Mae I would be personally able to witness this cosmopolitan work force that is reflective of our society which very seldom is the case. I think most of you will agree with that.

And I have to tell you, as hard as I try to get RTC to tell us (Maxine Waters and I), we can't get statistics on that, and I am very disconcerted about that because I was the one, with the Chairman's able assistance, who did all those amendments relative to making sure there was parity in the work force.

But I am also concerned when you give statistics like 34 percent. And I want to be assured, even though that doesn't mirror the female population which is 53 percent, and minorities added on would virtually be overwhelming, it appears to be better than a lot of agencies or a lot of financial institutions.

I once tried to get a GAO report done on where the executives were financial—maybe if they had more women and minorities we wouldn't have had all these failures, what do you think about that?

You are doing pretty well with people in the upper echelon, and I have no problem with paying people what is the market value, which a lot of people on this subcommittee feel is very important, as long as you represent a cross section of individuals and are able to examine their talents.

Mr. Brendsel, would you like to respond to that question?

Mr. BRENDSEL. Certainly, Congresswoman. Overall, excluding clerical people, we have about 50 percent women and minorities at Freddie Mac. But more specifically with regard to the top woman in Freddie Mac, she is the general counsel and secretary to the board of directors and a key advisor to me on matters related to legislation and everything else at Freddie Mac.

Ms. OAKAR. Is she paid comparably to all these other executive types or is the salary a lot lower?

Mr. BRENDSEL. Since she is sitting in the audience that might be a difficult question for me to answer.

Ms. OAKAR. I am not interested in knowing——

Mr. BRENDSEL. She is paid comparably in relation to other Freddie Mac executives. She, like our other executives, is being moved up to market compensation. We have been below market because of the history of compensation at Freddie Mac. We are trying to get her, as well as some other key executives, to market compensation before we lose them.

Mr. VENTO. Would Madam Chair yield?

Ms. OAKAR. Yes.

Mr. VENTO. Would that be above the civil service?

Mr. BRENDSEL. Yes.

Ms. OAKAR. In civil service, women and minorities are in the last five rungs of a 17-rung-level GS scale, and that has not been changed since 1921. So I am not really proud of the manner in which agencies—Federal agencies—move women and minorities up, let me tell you. And if that is true—and you can be sure I am going to be looking at it—then you are to be congratulated.

One last question which you don't have to answer in detail because my time has expired. I was very interested—you have done some great things—both of you—in my State of Ohio relative to low- and moderate-income, particularly in the last 2 or 3 years. And it is a real success, and I wanted to congratulate you.

I wondered if you could further document your agencies—institutions' commitment for the record. You have some of it in yours, Mr. Brendsel, but further document the kinds of programs you have begun that are very creative. I know they are working very, very well and what the future holds voluntarily for moderate and low-income people, as well as middle class people who also need a break in terms of having access to housing.

Mr. BRENDSEL. Pleased to.

Ms. OAKAR. Mr. Wylie.

Mr. WYLIE. Thank you, Madam Chairman.

I understand Mr. Leach in my absence asked for a recommendation on the range of capital standards. Treasury has not come up with what I perceive as a guesstimate on what their range should be. This is sort of like if you are following a truck, you say we should be 500 feet behind, we say you should be 700 feet behind and Treasury said you should be farther back than that. So we need to come up with something there, it seems to me, in the way of a range or estimate as to capital.

Did you hear my question which I asked Mr. Glauber where he said on page 3 of his testimony, "Fannie Mae and Freddie Mac's own internal estimate of their earnings and capital levels over the next 3 years indicate they will have no difficulty in meeting, through retained earnings, the administration's critical capital level, minimum leverage ratio, and any reasonable risk-based capital level"? Could you provide those internal estimates to the subcommittee to ascertain where you might be coming from? And they said they could not under the confidentiality of information provisions in the statute.

Are you under the same restrictions?

Mr. JAMES JOHNSON. We have never provided that to Treasury, and there were various other confidential documents that we did provide to Treasury. But we have never actually done an earnings projection and provided it to Treasury. The reason we don't do that is that is extraordinarily sensitive market information, and one of the things in the tradition of SEC regulations is that everyone in the securities' industry is most sensitive about is making any kind of prediction about earnings. It has a major stock impact, and it is something held more confidentially by private corporations then virtually anything else.

We could try our best to cooperate with you and the subcommittee to set some parameters or to perhaps aid in developing an analytical framework, but anything that looks like a specific earnings estimate is something that is extraordinarily difficult from a point

of view of confidentiality. So I don't want to be evasive in any way, but it is hard to be totally responsive.

Mr. WYLIE. What you are suggesting is when Treasury says your own estimates indicate you will have no difficulty in meeting their capital requirements, that they could not have had that information?

Mr. JAMES JOHNSON. They did not have that information.

Mr. WYLIE. We are one step removed from where I thought we were a little while ago. I do think we need to get together with them and maybe come up with something more than a moving target which we have had and you agree with that, too, I guess.

One quick, last question.

Mr. BRENDSEL. Congressman, could I make a couple comments?

Mr. WYLIE. Surely.

Mr. BRENDSEL. Again, I am not certain what information they think they have that we provided to them. I share Mr. Johnson's concern about confidentiality and market sensitivity to such kinds of information. In fact, we do not provide forecasts even to the marketplace because of the implications.

Nevertheless, I would go back to a couple basic points in this regard.

Number one, Treasury has not specified any kind of risk based capital test requirement for capital standards, so it is kind of impossible to have a discussion about whether or not we will or will not be able to meet any capital standards they propose.

Second, I also remind the subcommittee of Mr. Glauber's own statement before Congress earlier this year that the current risk to the taxpayer is de minimus in Freddie Mac and Fannie Mae. What better way of saying that we have adequate capital for the current risk that we take?

Now to the extent the companies grow, for mortgages in the future we should certainly add capital to support that growth.

Mr. WYLIE. I have one last question.

Ms. OAKAR. Could I just say I have made a commitment to Mr. Kennedy, who has another engagement, who has been here since 10 o'clock that he would have a chance to ask a question?

Mr. WYLIE. Why do you dislike the affordable housing provisions in H.R. 2900 so much? You both mentioned that in your testimony. As drafted, the amendment should be deleted. That is from your statement, Mr. Johnson.

Mr. JAMES JOHNSON. Our concern there is that it changes the character of the work we do with low-income rental housing from market-based financing to providing direct grants and subsidies. We think that when the subcommittee made the decision back in 1968 that there should be a separation with HUD and Ginnie Mae on one side for subsidized programs and Fannie Mae and Freddie Mac on the other side for market-oriented programs that was a very wise decision.

We do an enormous amount of work with low- and moderate-income renters. We have $19 billion of multifamily product that we currently hold. 80 percent of that is affordable to people at 80 percent of the median income in their area.

We have a very strong commitment to the program. We think this changes the character of what we do from being a financer to

being a subsidizer, and we don't think that is an appropriate change.

Mr. WYLIE. Thank you. Is that basically your position?

Mr. BRENDSEL. I would expand on that——

Ms. OAKAR. Not too long, please.

Mr. BRENDSEL. As Mr. Leach has noted earlier, we leverage ourselves. Our impact on the marketplace is through leveraging the capital that we have. In that way, we can provide the maximum kind of support to low- and moderate-income households rather than through specific kind of subsidy programs.

Mr. WYLIE. Thank you.

Ms. OAKAR. Thank you very much.

Mr. Kennedy.

Mr. KENNEDY. Thank you, Madam Chairwoman. I think I am not going to ask about what I usually ask about at this time, which should put you at some ease, although I continue to be very concerned about the multi-million dollar packages that seem to reward just the highest echelons of Fannie in particular, but I am concerned about Freddie.

I also just wanted to say, Madam Chairwoman, I think you bring up an excellent concern about the overall level of compensation for women.

And I hope that just because of that exchange that we don't see one woman's salary skyrocket to the level of the top CEO's and then see the rest of the women continue to be at substandard levels.

Ms. OAKAR. We want them all up there; that is right.

Mr. KENNEDY. I do want to just say for a quick minute here about cause and effect. I am not interested in having the Congress of the United States over-regulate compensation levels at either one of your organizations.

I don't think anybody—and I don't think that we want to hear statements about the fact that if we begin to get involved in your compensation levels that then the middle level people that you do need to attract are not going to be able to be paid competitive salaries as well.

The reason why the government has to act in both the compensation issue is because it is out of control, and the reason why the government is talking about acting in terms of the 20-percent commitment of profits is because, I think, of a general concern about the lack of involvement in the whole issue of affordable housing.

And that is what I really wanted to talk with both of you about this morning, which is that we have passed in this subcommittee somewhere in the neighborhood of, over the course of the next 10 years, roughly $70 billion worth of government-financed low-income housing.

That financing will require something in the neighborhood of three-quarters of a trillion dollars worth of private financing in order to achieve the goals that we in this subcommittee have outlined.

It seems to me that there is a very important role that both Freddie and Fannie can play in terms of assisting in programs such as HOPE, HOME, expiring use housing and a whole range of other

initiatives that this Congress needs to have funded through the private sectors.

You have both talked in general terms about new housing initiatives. I know, Jim, you have talked specifically about a $10 billion program dating back to last April or May, maybe it was March or April.

And yet we have yet to see the kinds of specifics, I think, that would lead me to believe that there really is a kind of commitment that is necessary to fulfill the mandate of the Congress, number one.

And number two, I think that that would do a large part, if we had some of those specifics, to diminishing the need for the regulation in terms of the 20 percent if we really had some hard commitments that indicated that you were really going out and achieving the goals that we so desperately need.

When you answered Chalmers, I think it was a minute ago, you said you didn't want to get out of the business of financing and into actually developing the housing.

I think you should do both. I think that is part of the mandate is to get out and get these programs developed so that we can have the kinds of housing programs that the subcommittee and the people of our country want.

Can you respond, please?

Mr. JAMES JOHNSON. Yes, thank you very much, Congressman Kennedy.

In regard to the $10 billion program that we announced this March, things are moving along very well in that program.

We have announced a special program for the elderly, a special program targeted at rural lending, a special program for employer-assisted housing.

And we so far—we have taken in about $2.4 billion of commitments under that program, so that is moving, and it is moving along pretty well.

Mr. KENNEDY. Maybe you can respond in writing because we are going to be out of time, but maybe both you and Mr. Brendsel can give us some very specific programs.

Also I would like to see in writing a response to the programs such as HOPE, HOME, expiring use, the FIRREA-mandated housing, the Federal Home Loan Bank Board-mandated housing, and any of the other programs that I am forgetting right at the moment that I can come up with that this subcommittee has passed that is going to require private sector financing over the course of the next several years.

Mr. JAMES JOHNSON. I would be happy to.

[The information referred to can be found in the appendix.]

Ms. OAKAR. Thank you very much.

Mr. Frank has questions, and he is on his way back, so at this point we will adjourn until Mr. Frank returns.

Thank you.

[Recess.]

Mr. FRANK [presiding]. Ms. Oakar is not able to come back.

Mr. Kennedy, I believe, has completed his questioning. Is there anyone else who has not yet completed his questioning?

If there is no objection, Ms. Waters has a statement she would like included in the record. And the Chair hears no objections, that statement will be included.

[The prepared statement of Ms. Waters can be found in the appendix.]

Mr. FRANK. I think you might turn on the questioning. Let me ask a couple of things. I do notice we are down to one stenographer. I thought perhaps we had three stenographers because we were following the Treasury's scenario of being very prepared for severe disaster and therefore we would be as ready, they would try to set an example.

I really have questions more for Treasury. I apologize for not having been here; but the Judiciary Committee, on which I serve, was to have an oversight hearing this morning with the Attorney General, who did not come.

And I had to choose between noting the absence of the Attorney General and taking advantage of the presence of the Undersecretary, and I chose the former.

I have a couple of questions which I am going to submit to them, but one in particular, and I must say that as one who agrees with the Treasury's analysis of the way markets work much of the time—and I am somewhat surprised by that position here because, as I understand what Treasury is telling us, it is that we can insist statutorily on increasing the capital requirements and be sure somehow that this will come out of the stockholder's equity and not out of the product.

Generally my friends on the Republican side and on the conservative side are the ones who take the opposite side of that. They are generally instructing Liberals that if we raise taxes or in other ways levy on appropriate sector entity, we have no guarantee that this will reduce profits, that it may very well drive up prices.

And I have not been able to understand how Treasury can be so certain in this case that levying on you, imposing higher capital standards will come entirely out of the stockholders' equity and won't result in a higher price of the product.

That doesn't necessarily make it wrong, but I do think Treasury has some obligation to do more than simply state that, given that they are usually on the exact opposite side of that issue.

Let me ask both of you, as they have presented their bill, are there mechanisms in there. And I know you don't like this idea, but under Treasury's bill, are there mechanisms that would guarantee that if, in fact, we raised capital standards for you that the—and as we say, that has to come out of somewhere, are there in Treasury's bill guarantees that this would come out of the stockholders' equity in both of your cases and not out of the price of the product?

Mr. Brendsel.

Mr. BRENDSEL. No.

Mr. FRANK. She is terrific, but she is not good with head shakes.

Mr. BRENDSEL. No.

Mr. FRANK. Mr. Johnson.

Mr. JAMES JOHNSON. No, there are not.

Mr. FRANK. I don't even begin to see the mechanism. I agree with that, and I think that is a serious flaw because we are talking

here about a product which has some benefit, and the benefit is lower housing costs which everyone agrees to.

That doesn't mean a priori that there should never be higher capital standards. It means you pay a price for those. That is relevant, it seems to me, because the kind of disaster scenario that they are talking about, as I read and Mr. Brendsel called to my attention, the disaster scenario in Mr. Weicher's testimony of mortgage rates being cut in half and housing prices dropping by 40 percent, 15 percent unemployment, I must say I think if that happened, we would be worried about us more than you two around here.

I think it is relevant to point out when we do comparisons between these institutions and banks, savings and loans, and so forth, we have already had, I believe, the worst real estate depression since the Great Depression of the 1930's.

I don't believe we have had anything comparable in terms of the prolonged, serious negative economic circumstances that are reflected particularly in the kind of real estate in which both of these entities invest.

We have survived that in very good shape. Apparently, the complaint seems to be that if anything, you are making too much money rather than too much at risk.

Again that does not suggest to me there is a great need to prepare for it since I am convinced that getting ready for the dooms day scenario will to a substantial extent come out of the product, the price of housing.

The other question I do want to address to Treasury, and I will send these along to them, but I will ask you also, I can't figure out quite what it is that people say we have implicitly guaranteed. We are told that we have an implicit guarantee. I think there is a semantic problem there. I think the implicit guarantee that you talk about a lot is certainly no longer implicit.

It might be—I think what it really is is an inferred guarantee. That is some other people have inferred that we guarantee it. But I need to know what it is that we are supposed to have guaranteed.

The analogy cannot be to banks and thrifts because in banks and thrifts there are deposits. In the great majority of cases that I am aware of where there have been failures, we have not protected the stockholder.

Now, again, I think that ought to be very clear, whether it was Continental, the Bank of New England, it is not my impression—or the S&L situation, we have not, as we should not have, protected the stockholder, the equity holder. There are no analogies to deposits here, so I wonder if either of you have any idea when people tell us that we are somehow on the hook because we have these guarantees, what is it that we are supposed to have guaranteed.

Assuming it is not your stockholders' equity, you have nothing like deposits, what else have you got that we might be on the hook for?

Mr. BRENDSEL. I think generally when people talk about this, Congressman, that certainly they are not talking about stockholders equity. No one is suggesting that I know of that our investors are being guaranteed. I think the issue centers around our debt securities or our mortgage-backed securities that we issue——

Mr. FRANK. So that the theory might be that we have somehow guaranteed if I go into the market and buy—and I guess by now I should not do that for conflict of interest purposes, we have enough problems—but if I were to go into the market and buy one of your mortgage-backed securities, the theory is that if you couldn't pay off somehow the government is going to pay me off?

Mr. BRENDSEL. That is correct.

Mr. FRANK. And that is what we are talking about?

Mr. BRENDSEL. Yes.

Mr. FRANK. I have got to say, let me just say this. I think some of my friends who were pushing hard for the Treasury-type legislation are making a mistake. I would prefer to say to people, I would like to say it right now, if you have both mortgage-backed securities for Fannie Mae and Freddie Mac, I do not intend to bail you out if they fail as a Member of Congress.

I am not voting you any money. I don't think most other people are voting you any money. I think the more we entangle ourselves with it, the more we start giving you instructions, the better the case is going to be that we have done that.

I think the best way to protect the Treasury is to say as loudly and clearly as we can, buy mortgage-backed securities, here is their track record, here is what they do, but don't come looking to us if there is any problem, not that we expect there to be one.

Have any of you ever represented, either of you, that there is some government bailout coming if your securities fail? Mr. Johnson.

Mr. JAMES JOHNSON. On the contrary. On every document that we put out, every prospectus, it says explicitly that this is not guaranteed by the Federal Government.

Mr. FRANK. A very good point.

You know what I think you might want to do? I would like to ask the staff, let's compare, when this subcommittee did a bill about a month ago, we mandated that the new financial entities we are allowing under the bill contain such a warning, that is that if there is an entity that has both a depository institution and a non-depository institution, they put some language in their warning, we ought to compare warnings. If your warning is at least as good as ours—I really think this is a paradox in which people should be protected.

Mr. LEACH. Would the gentleman yield on that point?

Mr. FRANK. Yes, I would yield to the gentleman.

Mr. LEACH. Could I kind of issue a warning? First, I agree with part of this exchange, but we did bail out the Farm Credit System, which is a GSE, so there is some precedent.

Now, having said that, just again by way of warning, this bill legislates capital ratios and then legislates them as a ceiling, which is as close to a preposterous principle as I know in my time here in Congress.

Now, the fact is with the distinction between the administration and the Congress. I understand the frustration of our two witnesses in that the administration hasn't designated what a proper level of capital is. Instead, they are saying that they will give such expertise to an experienced professional to make certain judgments.

Congress is saying, we are going to mandate not a floor, but a ceiling, and the ceiling is low.

Now, if there is any history of the last decade or two, it is that too much capital is not a problem.

I know of no place where it has been negative, and lots of places where it has been a positive, but we are saying too much capital is a problem, and so we don't want them to have it.

Second, Mr. Johnson is saying, and I think he used a very precise figure earlier, $2.3 billion or something like, that they are going to raise more capital in the next few years.

Mr. JAMES JOHNSON. It is $2.5 billion.

It has already been put in place in 1990 and 1991.

Mr. LEACH. Two and a half billion dollars, which is going to be raised internally, so there is no problem going to the market with you because you have all this money coming from internal funds. But I will be darned if I don't think that Congress ought to say that we think there is a problem with capital, we think that it ought to be raised.

I mean the market is saying that possibly Freddie Mac needs a little more than Fannie Mae.

I don't know if that is the right judgment or not, but both of you are doing rather well, both of you have enormous capacities to raise money.

It isn't take from the stockholder, although it could imply dilution. I have talked to stockholders of your institutions who tell me they like how things are going, but they can't complain if Congress mandates a little more capital, and I, for the life of me——

Mr. FRANK. If I could say to the gentleman, none of it is relevant to what I was talking about.

I would like to address it, though.

I am trying to be more precise here.

First of all, with regard to whether or not we should do a ceiling or not, it is my understanding that under the bill that the chairman has they would be debarred from having more capital?

Mr. BRENDSEL. Mr. Chairman?

Mr. FRANK. Mr. Brendsel.

Mr. BRENDSEL. This bill does not provide a ceiling.

In fact, the genius in the proposal, in fact, is that it is dynamic, it adjusts to changing conditions.

Mr. FRANK. Sometimes there is dispute. I was not aware that there was a ceiling on the capital.

The staff that worked on the bill isn't aware of it, nobody is aware of it.

Mr. LEACH. But as I understand it, this says the regulator cannot require above a certain level.

Mr. FRANK. But that is different.

I would say to the gentleman, that is different.

Again, I think people on the Republican side——

Mr. LEACH. How is it different? Voluntarily——

Mr. FRANK. I am sorry. I am going to take back my time and ex plain to the gentleman, this is totally off the subject I am talking about, but how is it different?

It is different when you say there is a ceiling on capital, I understood the gentleman to mean, and I think others did, that somehow they would be illegally barred from having more capital than that.

The gentleman appears to think that what the regulator does is coterminous and identical to what entities do.

Mr. LEACH. That is——

Mr. FRANK. No, I am sorry.

The gentleman raised the subject, and the gentleman had his time, but I think there is a confusion that he has introduced that I just think needs to be dealt with.

No, this is no ceiling in this bill in the sense that they are somehow prevented if the market says that they ought to have more capital.

If they feel a need to have more capital, they can have more capital.

There is a ceiling on what the regulator can impose on them, but that is not—that is a very strange form of shorthand to say that it is a ceiling on the capital because that is all the regulator has to say.

Mr. JAMES JOHNSON. Mr. Chairman, could I comment on this?

I think it is an interesting point.

Mr. FRANK. Yes.

Mr. JAMES JOHNSON. If you look at the H.R. 2900 as drafted, at the end of last year, at the end of 1990, Fannie Mae would have been required to have approximately $4 billion in capital.

Today we have $5.6 billion in capital. We intend to continue to grow that capital.

Let me tell you why.

That is that we want to have, in fact, a very substantial cushion between what is required of us by the regulator and what we need to do our business because it is a dynamic——

Mr. FRANK. Excuse me, but you can talk to him about that on his time and your time, but that is not what I was asking about.

I just want to make clear, I don't regard it as a ceiling. I think this is a confusion here.

These are private sector entities.

I would rather stress that. I think people put the taxpayer at risk when they go the other way.

The gentleman is right; we did bail out the Farm Credit System. I voted against that. I thought it was a mistake.

I will say this: Things we do in agriculture we do which fortunately we wouldn't do anywhere else.

I do not think the history of America is that you can look at an analogy to agriculture and say that is going to happen to farmers and agriculture has gotten different treatment.

Some of the most conservative Members of this body, when it comes to agriculture, they never heard of free enterprise, subsidies are fine.

Somehow there is a footnote, I didn't read it, but in certain editions of Milton Friedman and Ludwig Von Mises and Friedrich Hayek, there is a footnote that says none of this applies to agriculture.

It is not in my copy, but apparently they have it in North Carolina in the libraries.

It says it in there.

So I agree with that. I don't think the evidence is such—and I would rather go the other way, but I would like to get back and say that if people are talking about—where I was, you do have, both of you have, Mr. Johnson said this, Mr. Brendsel, warning labels on the securities you sell that they are not insured, guaranteed or in any way backed by the Federal Government?

Mr. BRENDSEL. Absolutely; right on front page.

Mr. FRANK. I think that is a much more—I would say to my colleagues, those who say that despite that, we are somehow at risk if there is a failure, are engaging in a degree of self-fulfilling prophecy that puts the Federal Government Treasury more at risk than anything else I can think of.

Mr. BRENDSEL. If I could have just 30 seconds to respond to another comment that kind of slipped out of Mr. Leach's mouth——

Mr. FRANK. Oh, nothing slipped.

Mr. BRENDSEL. Mr. Leach said that the market is saying that Freddie Mac may need a little bit more capital than Fannie Mae.

The market is not saying that.

However, certainly the market is saying if this subcommittee, if Congress adopts an approach to establishing capital standards that does not reflect the unique risks of each of the companies, certainly any crazy thing can happen.

Mr. FRANK. Mr. Leach, do you want to respond? I am through if you have anything.

Mr. LEACH. Well, we have set a record in terms of the banking industry in indicating that the U.S. Government should not be in the first instance concerned with stock valuation. It should be concerned with levels of capital for prudential purposes. And if the prudential judgment is made that a level of capital should be raised, I would grant it could affect the stock price, but I would not grant that that should deprive the U.S. Government from setting that level. I acknowledge it could have an effect on the marketplace, just as it could have an effect if we created a Margie Mae, a third, or a Barnie Mae, a fourth kind of entity.

I am not advocating that that needs to be done, but in theory, that is a possibility, but I will agree it could affect the market.

Now, I don't think anybody on this subcommittee should be too concerned about the holders of stock in your corporations.

They have done mighty well, partly because they have been pretty well led, and partly because of unique market opportunities that you have taken advantage of in the last 2 or 3 years which has served the public interest in my judgment. I don't want to deny that your two institutions in the last 3 years in terms of the public turmoil in housing have served the public interest incredibly well, and that is my own judgment.

That doesn't mean that I think you are adequately capitalized, and it doesn't mean that I think Congress should pass the bill as it is currently crafted.

Mr. FRANK. Mrs. Roukema.

Mrs. ROUKEMA. I want to say here, here to what Mr. Leach has just said, and I must say that I think there is a note of unreality about my colleague, Mr. Frank's analogy here in saying that be-

cause you have the disclaimer there the Government has no responsibilities for your activities.

First of all, it is called a Government-sponsored enterprise, OK?

We have already heard the references to the fact that there are obligations here with respect to your securities, your Government-backed securities, your mortgage bonds, et cetera.

What were we discussing when we discussed too big to fail, for heaven's sake?

The reality here is I don't care what the technical analysis that you make versus another sharp lawyer's technical analysis, we are going to have a collapse of major proportions on our hands that this Government is not going to let happen if we——

Mr. FRANK. Would the gentlewoman tell me what collapse she is talking about?

Mrs. ROUKEMA. If we move to people or practices that are not reliable as we saw in the savings and loan and the commercial banks, so thank God in these harsh times that we have had such well-managed enterprises here.

But that could change at any time, and we are not writing legislation here for whoever happens to be the regulator at any particular point in time or whoever happens to be in the management, nor, might I say, now getting on to a different point, and Mr. Brendsel, I don't mean to be harsh, but I have got to take exception because you have equated increased capital requirements with being a tax on your board members?

That was what I understood you to say. I thought it was—in the body of your testimony. But anyway, the inference was there, and that is why I wanted to second what Mr. Leach said with respect to the fact that your board members and your stockholders have been doing well, as they should, as they should, because they have been well-managed enterprises.

Now, let me just ask—this capital question is getting more and more thorny here as we go along, and since I haven't had the benefit of your full test and the full discussion here, I do want to go back to something that Mr. Johnson said because he was rather specific and direct and to the point about his criticism of the Treasury approach, even accusing it of being a cut-and-paste version.

You indicated that your test for capital is dynamic, and I understand that it is, but as I heard Mr. Glauber's testimony, and something that Mr. Weicher, I think, concurred with, it sounded pretty dynamic using different standards and different measurements than you did, but it sounded dynamic as well, which was his basic argument for not having firm ceilings—floors and ceilings, as I understood it.

You could just explain a little bit more to me as to how your approach is—why your approach is the favored dynamic approach from your own perspective, and isn't it fair to say that that is precisely the quality that Treasury is looking for, using a different method?

Mr. JAMES JOHNSON. Let me try to do the best I can. There is a lot of conflicting strains in all that is being talked about.

We believe that the capital approach should be one that adjusts to the changes in the risks that we take, so today, for example, the 30-year Treasury bond is about 8½ percent.

If that goes up to—we actually use the 10-year Treasury for purposes of this stress test, but suppose you take an 8-percent benchmark and all of a sudden that is 12 percent rather than 8 percent.

Our view is then the capital requirements on Fannie Mae and Freddie Mac should be required to adjust and adjust immediately as soon as those——

Mrs. ROUKEMA. But isn't that what Mr. Glauber was testifying to and claiming for his own approach?

Mr. JAMES JOHNSON. I think that in terms of having a dynamic stress-oriented capital standard, we are not in substantial disagreement.

The difference is who sets that?

What we are saying is that we believe that that ultimately is the balance between safety and soundness and housing, and, therefore, we believe it is very appropriate for Congress to set that balance.

What Mr. Glauber is saying, he thinks that that should be delegated by Congress to HUD, so that HUD could go through a process, as the subcommittee staff has done, of looking at various stress tests, as Fannie Mae and Freddie Mac have done, of looking at various stress tests and that HUD should come up with its own stress test, and that should be the one that applies to us rather than the one that the Congress would enact.

He argues for that on the basis that that would allow for additional flexibility, and it would allow the regulator a good deal of discretion.

What we are saying in response to that is that we believe if the stress test is dynamic and it represents the policy of the subcommittee, that is the balance that the subcommittee wants between safety and soundness in housing, then the subcommittee should make that decision, and the Congress should make that decision.

The other quarrel that we have with Mr. Glauber is one that I alluded to earlier when I was talking with Congressman Leach, and that is that one of the problems—Congressman Wylie also talked about this—what we have is that the Treasury has now been at the assessment of Fannie Mae and Freddie Mac for 2 years.

HUD has been at it, in the case of Fannie Mae, for 23 years.

Neither organization has come forward with a stress test that has specific principles, specific assumptions, and that generates a specific number, so the subcommittee staff has put on the table, and you in your introduction have put before us an approach where we can say, "Okay, we take the committee's approach. We apply all our assets to it. We apply that approach to us, and that requires on a date certain $4.1 billion of capital.

That has never been done by Treasury and HUD, so we don't have a reference point from them as to what the alternative approach would be.

Mrs. ROUKEMA. That is what I was trying to get to.

Mr. JAMES JOHNSON. That is why we are much more sympathetic, frankly, to the approach of H.R. 2900 because it is specific, and, therefore, we know how to relate to it.

If Treasury would come forward—Mr. Glauber says in some words, he says if I were to do it today, it would be OK with you, Fannie Mae and Freddie Mac, that is what the bottom of page 3 is all about.

He says you can reach the stress test I think I would come up with, but since he hasn't come up with it, we can't evaluate it. It is just as simple—if he were to come up with it and it generated a number and it had an approach, we could then compare that approach with the subcommittee approach and see where we should go, whether it is halfway in between or whether we should go up some or you should come up some or what should be done, but since we don't have a reference point, we can't make that comparison.

Just one last sentence on that is that we intend to continue to build our capital, and we continue to build—we intend to continue to build the cushion above what is required of us.

I hope by yearend that we will have more than $2 billion beyond what is required of us in this draft.

We are going to build beyond that because we don't ever want to be in a situation where if these dynamic changes occur, all of a sudden we can't do the business for housing that we are chartered to do, so we are going to have a good deal of cushion, a good deal of excess capital so that as circumstances change, we don't have to constrain our growth all of a sudden and can't do the mortgage business that we have been constituted to do.

I hope that is not too confused or lengthy.

Mrs. ROUKEMA. No, I think it has been helpful. We are still waiting to hear more from Treasury, as you know.

I presented an open-ended question to them, and we hope that they take our offer and work with us on it.

Thank you very much.

Thank you, Mr. Chairman.

Mr. FRANK. I just want to respond since the gentlewoman accused me of unreality.

I am struck by the lack of intellectual rigor on the part of some of my colleagues.

I think they are being self-defeating with this notion that, oh, sure, here on the hook.

In fact, the gentleman said what is the point of these warnings, it is unreal.

Well, the majority of the subcommittee didn't think so. The majority of the subcommittee, I think, correctly structured entities that will be formed here, and it was something that was taken with a great deal of seriousness that when they sell securities that are not insured, they have to put a label on there.

Now, maybe the gentlewoman thought that was unreal.

Mrs. ROUKEMA. That is true. That is true.

It is hyperbole to point out there is a real problem here, and there is a real reason why we are attacking this problem.

Mr. FRANK. I yield to the gentleman from Iowa.

Mr. LEACH. Well, first, let me stress to the gentleman that I personally have a great deal of respect for the intellectual rigor of the majority of the subcommittee.

I think it is intellectually very rigorous.

Now, having said that, there is a—Mr. Johnson——

Mr. FRANK. I want to finish on my response to the gentlewoman from New Jersey, I will be glad to yield to the gentleman. She raised the point——

Mr. LEACH. I know, but let me come back.

Everybody understands that one of the distinctions between these two institutions was that Mr. Brendsel's institution had a higher percentage of mortgages that, in effect, were immediately securitized.

Mr. Johnson's institutions didn't.

With a lower interest rate circumstance, Mr. Johnson's institution has been the winner in terms of profitability.

Now, if interest rates had gone substantially higher, as they did in the early eighties, I think Mr. Johnson's institution would have been in a little more difficulty.

Mr. Johnson is now saying that they are going to be protecting themselves to a greater degree in the future, both with higher capital and in managing their risks. If it weren't for the luck of the macroeconomic economy, coupled with excellent leadership—including Mr. Johnson's predecessor who I and many people complained got too high a settlement—this Government would have been on the hook potentially for billions and billions of dollars that it isn't. Thank the Lord that it was as well run as it was, and so to some degree, that is a justifiable settlement, although I object to it. Having said that, when you talk about reality—and I come back to the chairman, the acting chairman of this subcommittee is correct in saying that I exaggerated the point about there being a ceiling. But in terms of reality, when the Congress places a minimum level and says that regulators cannot insist on a higher level, that does have the effect on many kinds of institutions of saying, "Well, we like to leverage so we are not sure we will go above it."

Now, Mr. Johnson has said to us that he is going to go above that, and that is impressive.

Mr. Brendsel may or may not. I don't know, but I would say that the history of American regulation is that many kinds of financial institutions in the real world of reality like to leverage to whatever extent regulators let them.

Mr. Johnson has said he is not that kind of leader, but he might be followed by someone who is, which is more general.

Now, in addition, if we talk about the real world, Mr. Brendsel has testified that his institution has been, in effect—I repeat this—40 to 50 times smarter than Citicorps and at least 4 times smarter than Chase Manhattan.

Now, I hope it continues to be, but I can't, in the real world, assume it.

I just can't.

Based on that, I think it is realistic for us to be very concerned with levels.

Mr. FRANK. I want to respond. What both of my colleagues have objected to is my paying attention to what they said. Maybe I shouldn't do that in the future. You are saying, well, that is what I said, but that is not what I meant. I am better at what you said than what you meant.

The fact is, yes, I understand. When a regulator says, as far as I am concerned, you have to know this high, that may lead some people not to go any higher, it may have that effect, but that is not what we were talking about.

The gentleman said a ceiling. I think everybody understood a ceiling to be a limit above which you can't go. It is also the case, and we are not talking here about dozens and hundreds of institutions, we are talking about two particular institutions which are very much in the spotlight, and I think the gentleman's analogy between these two institutions and dozens and hundreds of others that are regulated is imprecise to a degree that makes it inappropriate because I don't think they have those kinds of options.

These also are two institutions which unlike a lot of others have an ultimate purpose, other than making money, but how they make their money, which is a little bit more socially favored to me, and that is the point I want to make, that there is a housing affordability tradeoff here that isn't necessarily the case in other places, but now I want to go back before the gentleman diverted me to the point of my friend from New Jersey on the unreality.

I want to stress two things. One, I do think there is some point to these labels, but this is my most fundamental point. I find it paradoxical that people in the name of protecting the Treasury are making a better case for people to come to us if there is a problem than they should be.

The better way to say it, I think, is to say to these people, look, it says it right here, there is no government guarantee, the government is not guaranteeing this.

What my friends do when they go the other way is, in fact, to make more likely that which they say they are trying to forestall.

Mrs. ROUKEMA. Well, this discussion could go on forever, and I suppose that neither one of us would—one might win, but not conclude the argument. Let me just say that I think your logical conclusion, then, would lead you to say, well, then, we better privatize this whole thing, let's privatize the whole thing, but short of that, then we have the obligation, that is the reason it was put in the law, to do something to oversee or whatever this situation.

Mr. FRANK. That is why we are here.

Mrs. ROUKEMA. That is why we are here. That is the only point I was making.

Mr. FRANK. Mr. Brendsel, you wanted to say something if you insist on interrupting.

Mr. BRENDSEL. This is an interesting conversation, but it is also serious in terms of implications and results, so I didn't want to let Mr. Leach's comments go unanswered in part.

First of all, I didn't say we were smarter than City Corp. or Chase. Now, from time to time, we are, as from time to time, Fannie Mae is. It is also true that we approach our business differently.

We are the secondary market. We have certain additional protections, layers of protections against loan losses that, in fact, a City-Corp or Chase have. So the way we do business is different. In part that is because of charter.

Second, with regard to talking about raising more capital in the future, my position first is we are adequately capitalized now for the risk we take now. As we grow, as those risks change, we will and we should add capital.

Certainly, we plan to do that. Now, certainly this proposal that is on the table is very dynamic, and, in fact, in reference to Fannie

Mae in the early 1980's, it would have required an enormous amount of capital to be held against the interest rate risk that that institution had at that time.

That is precisely the of this particular proposal. Again, to illustrate how tough these capital standards are, Mr. Leach, I don't think you were here during my oral statement, and I want to reiterate a couple points. If this stress test for capital and interest rate risk were applied, for example, to a thrift holding a portfolio of residential primarily fixed rate mortgages, it would require that institution to hold double the amount of capital that is currently required under risk-based capital rules.

It is a very tough standard—it would require that thrift to hold twice the amount of capital required under risk-based capital rules today.

A final point is, as part of all these studies, Standard and Poor was retained to rate these companies absent their implied government guarantee. In fact, we worked with them and shared our information with them, and they wound up concluding A-plus. It is not the highest rating it could have been, but do you recognize how many thrifts or banks there are whose subordinated debt is rated A-plus or better today? You could count them on two hands.

Mr. FRANK. We will let Mr. Leach make a comment.

Mr. LEACH. I do think it is fair to say that Mr. Johnson is a poor student. He has only an A-minus. Wasn't that the same study? I may be wrong.

Mr. JAMES JOHNSON. Let me make just one quick comment about the City Corps and Chase Manhattan. I never want to be in a position of turning down even an implied compliment, but I think the problem here is that we are measuring two different things in those statistics.

Mr. LEACH. It is apples and oranges.

Mr. JAMES JOHNSON. What you have is their current delinquency rate.

Mr. LEACH. The delinquency rate was 4.8 percent at the end of March.

Mr. JAMES JOHNSON. What we are comparing here is a delinquency rate to a default rate as opposed to a delinquency rate to a delinquency rate. We would be happy to give you in writing a comparison of their actual default rate with our default rate.

You will see that they are much closer together.

Mr. LEACH. You are not much smarter, just a bit smarter.

Mr. JAMES JOHNSON. That is right.

Mr. FRANK. Mr. Leach, do you have one final——

Mr. LEACH. I do have one final inquiry.

Let me begin the inquiry with the observation, not only are these two extraordinarily fine leaders of American finance, but I think our Chairman is an extraordinarily able Chairman.

Now, having said that, let me just ask, because this is one of the areas in which our distinguished chairman is one of the Congress' and the country's leading experts, would either of you have any objection to applying the anti-trust laws of the United States to your institutions?

Mr. JAMES JOHNSON. Absolutely not. They apply currently.

Mr. LEACH. OK. Fine. Thank you. You agree with that, Mr. Brendsel?

Mr. BRENDSEL. Yes. They currently apply.

Mr. LEACH. Well, my great feeling on anti-trust is that we ought to apply them to Congress.

Mr. FRANK. Any further comments?

If not, I thank the gentleman.

We didn't have anti-trust for a while under Reagan, but we have it again now.

The subcommittee will reconvene at 10 o'clock tomorrow morning.

Some people will be here and some people won't, but the subcommittee will reconvene at 10 o'clock tomorrow morning, and this hearing is now adjourned.

[Whereupon, at 2:20 p.m. the hearing was adjourned subject to the call of the Chair.]

GOVERNMENT-SPONSORED HOUSING ENTERPRISES FINANCIAL SAFETY AND SOUNDNESS ACT OF 1991

FRIDAY, JULY 19, 1991

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Henry Gonzalez [chairman of the subcommittee] presiding.

Present: Chairman Gonzalez and Representative Kennedy.

Chairman GONZALEZ. The subcommittee will please come to order.

The Chair would like to observe that this is one of the first Friday sessions for hearing purposes that we have had for the subcommittee and with the House not being in session, most of the membership is out of the city.

However, as of yesterday I had been assured by a goodly number of members of the subcommittee that they would be here this morning. So I would anticipate that a few of the members will be forthcoming as we go.

However, I don't think we ought to prolong inasmuch as we have a very, very substantial number of witnesses. I want to say also that even though the members may not be here, everyone has a copy of the testimony thus far received. This is a continuation of the hearings that we initiated some time ago with respect to the government-sponsored enterprises.

Each one of the members will have your testimony and a transcript of the proceedings so that in case they have any questions they may wish to submit in writing, they will have to do so in time for you to be able to address the questions expeditiously for the hearing record.

For the sake of expediting the proceedings today, and that we not make the witnesses listed at the end wait an inordinate amount of time, we will proceed and as the members arrive we will go on. I will dispense with any formal opening statement. I will see to it that it is placed in the record of the proceedings at the outset.

[The information referred to can be found in the appendix.]

Chairman GONZALEZ. I will now recognize Mr. Daniel F. Evans, Jr., Chairman of the Federal Housing Finance Board. Thank you again, Mr. Chairman.

You may proceed as you deem best.

STATEMENT OF DANIEL F. EVANS, JR., CHAIRMAN, THE FEDERAL HOUSING FINANCE BOARD

Mr. EVANS. Thank you, Mr. Evans.

First of all, my thanks to you and your staff and the other members for permitting me to testify the first thing this morning. I greatly appreciate it.

When last we were here 6 weeks ago we reported the good news and not so bad news with respect to the Home Loan Bank System.

Today basically the situation remains the same, that is that the Federal Home Loan Bank System remains safe and sound, it continues with its triple A rating without the implied guarantee of the taxpayers. The Federal Housing Finance Board has aggressively pursued its safety and soundness mission and is in the process of examining each of the 12 district banks.

We have completed a number of examinations and we continue our examinations. The mere fact that we have 12 district banks as opposed to the other GSE's which are one-entry organizations causes us to go more closely than we would desire but we are aggressively pursuing that and achieving some results.

As I forecasted at the last hearing, Mr. Chairman, the marketplace as usual is leading us. We are not leading the marketplace. Our advances outstanding to members as of June 30, 1991, are $94.740 billion. Six weeks ago when I last testified that number was $100 billion. So the decline in just 1 month has been a little over 5 percent.

We think we are looking at the bottom of that shortly as the RTC continues resolving failed thrifts. There is nothing uncertain or unpredictable about this except it is putting a terrific strain on the system's profitability. We now hold approximately $55 billion in nonadvance assets which is a pretty fancy way of saying investments in overnight deposits. That puts the Federal Home Loan Bank System in the position of being one of the largest if not the largest holder of overnight deposits in the country.

Holding overnight deposits and making investments is not the business of the Federal Home Loan Bank System. The business of the Federal Home Loan Bank System is assuring its members can make mortgage loans, fund affordable housing projects and going about the business of seeing to it that America is well housed.

We don't like to be in the position of managing a portfolio which is as large as it is. We are very mindful of that responsibility that is placed upon us in doing that. So following through on the theme that the market is leading us, the obverse of that is artificial nonmarket constraints are holding back our ability to maximize servicing the home mortgage industry in all of its phases.

One way or another, we must have voluntary membership at some point in the future for our present members, our thrift members who got us to where we are today. I would like to point out that the thrift industry, although it continues to be battered and bruised by the transgressions of those in the past, those that are surviving are healthy, well run, well managed and a great many of

them, the data shows this quarter and last quarter, actually turned a profit.

I think Mr. Holland of the U.S. League testifying sometime after me hopefully in his oral statement will get into more detail on the upward curve that the industry now finds itself in and the fact that those that presently represent the industry are not those that got us into the fix that FIRREA addresses.

There is no reason to be afraid of voluntary membership. The Boston, New York, and Pittsburgh banks of the Federal Home Loan Bank System all have a large number of voluntary members. In each of those banks none of the voluntary members has asked to withdraw from the system. I attribute that to their feeling that there is a value in the system.

They are able to borrow advances at very competitive rates, pass those savings along to their customers, mortgagors, and go about their business in a profitable way. In the Boston Bank System I believe half their members are voluntary and none have withdrawn. The first application after FIRREA to join the bank system was from the Boston district. But we must meet our obligations imposed under FIRREA.

FIRREA imposes on the Federal Home Loan Bank System two major obligations that cost real money. The biggest is the $300 million we are required to pay REFCORP in interest payments each year. The second of those is the Affordable Housing Programs required under the statute which will cost between $50 and $100 million a year depending on the profits of the system.

As the Chair well knows and as I conveyed to the Chair after our meeting in a personal letter, we have been successful beyond our wildest expectations with the Affordable Housing Program. I would like to recognize the good work of the staff of the Finance Board, Sylvia Martinez particularly, in our affordable housing division.

The applications for Federal housing funds outstrip our ability to service them. Housing has become less and less affordable to the middle American as well. That is the reason we are chagrined that we are sitting on top of $55 billion in cash or cash equivalents which are not out there servicing mortgages today.

We think we need to make sure that all members are treated equally within the system both commercial banks and S&L's. We need to serve the largest possible percentage of the home mortgage market. I feel a little bit like the base closing commission, dealing with fewer soldiers means you have fewer bases. We have fewer members so we are going to be serving fewer mortgagors as time goes on unless we are able to expand our membership.

The Federal Housing Finance Board has strongly encouraged each of our district banks, and I mean encouraged in words of one syllable that among their missions is to attract new members. The Federal Home Loan Banks have been successful in attracting new members. Now we must convert those new members to new member borrowers. We still remain on the outside edge, hopefully the leading edge of the recession.

We believe as the recession dies down and the economy perks up and the signs are that that is occurring now, the demand for new commercial bank members will pick up.

This is a very tough issue, Mr. Chairman, and I know that you will hear testimony about this from others today, but we feel a strong sense of responsibility to assist this subcommittee in figuring out a way to come up with a formula or a plan to service in the most fair way to our present members that vast number of potential mortgagors out there who deserve the benefit of the Federal Home Loan Bank System which after all raises its money with the implied guarantee of the U.S. taxpayer.

Last and of immediate importance to the Federal Housing Finance Board and as shown in the budget report, the Federal Home Loan Bank System is over capitalized; because we are over capitalized not much attention is focused on us. The attention is focused on those entities which some may believe to be less capitalized, some may say under capitalized.

The law requires us to take back from a member 5 percent of the lendings in capital stock. The capital stock purchase requirements which vary between thrifts and commercial banks, and right now the Federal Home Loan Bank System has capital of $11.2 billion. I think that is about 7.3 percent. I am not sure.

It is between 7 and 8 percent. That costs our members real money. The CBO is very clear in their report about the effect of our capitalization on our members. Our members are required to tie up more capital in their mandatory ownership of Federal Home Loan Bank stock than the marketplace requires for sure. Since 1933 the Federal Home Loan Bank System has not experienced a single loss, on a risk adjusted basis, our capital would approach 30 percent if not actually be there by now.

This situation of over capitalization truly puts our members at a competitive disadvantage with others who use other funding mechanisms that require less capital.

Last, we have to deal with efficiencies. The Federal Home Loan Bank System is comprised of 12 district banks. The statute requires us to keep a minimum of eight district banks. I believe that those district lines were drawn sometime in the Great Depression even though the district banks have moved since then.

We are under pressure to operate the system as efficiently and economically as possible. We would like to come back to the subcommittee working with our industry and shareholders on a proposal to give the Finance Board the discretion to redraw the lines of the Federal Home Loan Bank System and perhaps reduce the number of Federal Home Loan Banks to less than eight. At this time we are requiring them to operate at the highest level of efficiency and in their portfolios and managing their lending practices in a safe and sound fashion.

To avoid the risk of being repetitive from the appearance I have no further remarks. I will be happy to entertain any questions at this time. That completes my oral statement.

Chairman GONZALEZ. Thank you for having given us the written, printed text of your testimony.

[The prepared statement of Daniel F. Evans, Jr. can be found in the appendix.]

Chairman GONZALEZ. You mention in your testimony that commercial banks have significantly increased their role in the origina-

tion and funding of residential mortgages and now originate more housing loans than thrifts.

Do you have any statistics?

Mr. EVANS. We believe the data shows now commercial banks represent over 40 percent of mortgage origination and thrifts represent about 25 percent of the market.

I am completely aware of the fact that different organizations have different numbers, but the trend remains the same and that is commercial banks are taking an ever increasing share of the mortgage origination market.

Chairman GONZALEZ. What would be, if you have the statistic, the average mortgage amount involved that the banks are financing?

Mr. EVANS. Do you mean average mortgage balance outstanding?

Chairman GONZALEZ. Yes, what is the average cycle of the mortgages that the banks are financing? I would say it is certainly not in what we would call the affordable housing range.

Mr. EVANS. No, sir, I would doubt if it is in the average or the medium.

Chairman GONZALEZ. The banks never have and never will, unless there is some additional factor there. Even with subsidies this is the reason why the system was set up to begin with. If this is true then, of course, we want to make sure that we analyze it because you also state that, in fact I think you kind of stressed the need for expanding the membership in the Federal Home Loan Bank System.

As I interpret your statement you are asking us to look, even with those remaining impediments, to the commercial bank membership now. Yet you are not proposing that Congress adopt a voluntary membership at the same time, are you?

Mr. EVANS. No, we are not specifically linking the two to the exact same moment in time, that is correct. But the reason for that is that it is tied to our capital requirements. We also need the authority under statute to set our capital requirements.

Once we have a notion of what the acceptable capital requirements are, then an advance for how much capital should be in the system, and from whom, can be decided. We are in active conversations with all interested parties including the subcommittee's staff on that very issue, what are our capital requirements and therefore what should be the mix of our membership stock purchase requirements.

Chairman GONZALEZ. Well, we received a package from your legislative aid Steve Britt reflecting a proposal by the board in that respect.

Among those issues are the possibility or the likelihood of a need to establish comparable capital standards to Fannie Mae and Freddie Mac and the need to otherwise equalize the status of Fannie and Freddie and the banks.

Then would that be tantamount to proposing lowering of the capital requirements? What would be the thrust of that suggestion?

Mr. EVANS. The amendments I think you are referring to were turned over to your staff. They were drafted by the staff of the Finance Board. They have not been approved by this subcommittee or the Finance Board. It was an effort to engage a dialog on that

subject. As I said in May and in my testimony today, as well as echoed in the several GSE reports, yes, Mr. Chairman, we have an abundance of capital that puts our members at disadvantage. They have to tie up a great deal of capital in order to get the advance program, the advance window.

Yes, the effect of that would be to lower the present capital in the system in a manner that would not jeopardize our REFCORP funding or affordable housing contributions.

Chairman GONZALEZ. In other words, consistent with the REFCORP requirements.

Mr. EVANS. Yes, sir, we were very much aware that we have to make an annual payment to REFCORP. Without any change in demand or our product, we predict that the REFCORP contribution will take up 39 percent of the system. That will have the effect of driving down the amounts for dividends which will have the effect of driving down demand for advances and in turn will drive down the system profits and drive up the REFCORP's presence in the affordable housing area.

Those patterns cannot be ignored and we cannot pretend that they are not linked together.

Chairman GONZALEZ. I realize that H.R. 2900 was just introduced. If you or your staff has had a chance (to review H.R. 2900), how do you consider the capital requirements as we described them in H.R. 2900 with what you feel would be a stream of consistency of Federal requirements.

Mr. EVANS. We have no guidance from Congress today or no clear mandate as to what our capital requirements should be. That bill focuses as is predictable on those that possess a great deal less capital than we do, namely Fannie and Freddie. We have brought that issue up at the staff level within the Executive Branch and within Congress several times that we require some guidance.

I think the CBO report, of all the reports on GSE, clearly puts the responsibility back. It does not say what the adequate capital requirement is. It just says that a capital requirement needs to be developed for the Federal Home Loan Bank System.

Right now, there is one implied in the existing statute which requires a member, an S&L when it borrows to buy 5 percent stock so you are automatically going to have 5 percent capital supporting that borrowing. That 5 percent is considerably higher than the requirements placed in the bill on Fannie and Freddie.

We have no intention of paying down our capital under any scenario to some minimum amount. What we want is clear authority to develop capital guidance and the discretionary authority to deal with it in a fashion that is quick enough that it mirrors the marketplace.

Chairman GONZALEZ. Well, the CBO report indicated that both of those two entities were adequately capitalized at present. What I am getting at is, in H.R. 2900 we are suggesting parameters within which, without necessarily setting a fixed ceiling or whatever, and that in itself, as interpreted by the Freddie Mac staffs, leads them to conclude that if H.R. 2900 were adopted as it is now written, they would have to come up with an additional $1.5 billion in capital.

So if you would look into that or have your staff evaluate it from that standpoint and as to the goal that you are seeking with respect to equalization of capital requirements, I will appreciate it.

Mr. EVANS. We will. Right now, Mr. Chairman, taking 2900 and looking at the regulatory capital levels and the risk based capital and the stress test all incorporated in, applying that to us today would put us at about 30 percent capital. We have it. It is not that we don't have it. We do have it. We don't have to earn any more to get up to that point but we don't want to earn less by virtue of having too much capital.

Chairman GONZALEZ. I understand. I think that is another matter. Everybody I think agrees that the ideal thing is to seek an adequate capital base, that you don't want to go to the other extreme and have an overcapitalized requirement where one extreme is as bad as the other. I think you are right. It is unrealistic.

Mr. EVANS. Buried in the old Federal Home Loan Bank statutes are all sorts of requirements. I am a lawyer and extremely nearsighted. So I tend to tucker out about two paragraphs into it. We are intensely analyzing why the Federal Home Loan Banks carry 7 to 8 percent capital when in fact the only people providing that capital are members.

It does not result in the most efficient mechanism for providing Home Loan Bank Board mortgage money to their members with which they can provide their mortgagors and customers. That drives down our profit which impacts our ability to meet the REFCORP payments and the affordable housing payments.

We find ourselves in the enviable position of dealing with too much, not too little. We also feel the same sense of responsibility we do with the $55 billion in investments. It is not a responsibility we take lightly. We realize there is a very real possibility that our capital can become a wasting asset.

We don't want that to happen through inertia on our part or lack of attention because it is not a problem to others. So we come here today not to sound the alarm, but to do as we did last time, to beg the subcommittee's indulgence to come up with a formula.

The system has been through stress before. With each recession comes the decline in demands for mortgages.

Chairman GONZALEZ. I agree with you. It is something that we are planning. But by necessity, given our available legislative work time, we were planning to do that early in the fall, as soon as we came back in September. But we do intend to address that.

Mr. EVANS. We hope to work with the subcommittee and its staff in the meantime.

Chairman GONZALEZ. Yes.

Mr. Kennedy.

Mr. KENNEDY. Thank you, Mr. Chairman.

I was interested in your testimony regarding the Affordable Housing Program. I think in many cases the success of the Affordable Housing Program that the Federal Home Loan Banks have achieved over the course of the last year or two, are you fairly confident about the program at this stage or what?

Mr. EVANS. FIRREA created a scheme within which affordable housing would be, for lack of a better word, imposed on the system and the members. The Finance Board has tried its level best to try

to meet both the letter and the spirit of the law. I must say, Mr. Kennedy, that the Federal Home Loan Banks have responded in kind.

The proof of the pudding is the fact that our applications for those funds have far outstripped demands. We have done a few simple things to make it easier. My first act as chairman was forbidding the staff from developing a form for the people in Iowa or wherever. Let those folks out there deal with their folks.

Because it is a fixed percentage of our profits, the funds available this year were $53 million. Last year, it was closer to $80 million. That is the reason why we think we should drive up profits. As to why I said last time I consider the affordable housing element of FIRREA an agency's status, the performance has been outstanding. That is due to the imposition of FIRREA which we embraced and aggressively pursued and the fact that we have a whole host of, in fact, unpaid advisory committees throughout the country who tend to be representatives of the community-based organizations, those who put together the deals.

We try very hard to monitor not only the funding of it but construction, are things up and running? Are people being housed. Right before our last appearance before this subcommittee, we held hearings out in the field and visited a few affordable housing sites. We heard some fascinating testimony from both the industry and from those who have benefited from it which gave us an insight into some of the problems we might look at.

Mr. KENNEDY. It should like you have been able to make the transition despite the initial shock or difficulties. You have been able to make the transition and feel considerably confident no only running the programs, but actually trying to assist the people on the ground in terms of some of the problems that they face as well, correct?

Mr. EVANS. Yes, sir. Absolutely.

Mr. KENNEDY. I am very interested in this. Yesterday, we heard testimony from the GSE and I think Jim Johnson himself indicated that he felt that the imposition of the 20-percent program would be very difficult because it was changing the mission of the GSE from, I quote as I recall, housing finance to housing subsidy.

Yet it seems to me that this is a very find example of how a program like this in fact can be implemented through the institutions such as the Federal Home Loan Bank system or the GSEs. So it seems to me that the notion that somehow this is outside of their capacity and capabilities is really just inaccurate, if given an opportunity that there are determining factors that would allow these programs to take place.

Do you have a return on equity? Do you have any kind——

Mr. EVANS. For the system?

Mr. KENNEDY. Yes.

Mr. EVANS. It is about 8 percent right now.

Mr. KENNEDY. I was interested to hear Mr. Glauber yesterday indicate that the GSE's return on equity is about 35 percent. So it seems to me that given an 8 percent return that generates still 52, $53 million and the ability of this program to succeed, certainly indicates a capacity on behalf of the GSEs to be able to implement programs as well.

So I am delighted to hear that the program is moving forward. If we hear of some other issues that come along the way, I would like to come back and have further discussions with you.

Thank you, Mr. Chairman.

Chairman GONZALEZ. I just want to sum up here. With all of this and everybody touting the fact that the secondary market institutions, and others, that they are providing so much for housing, why is it that out among the people the reports are that the average family is priced out? They cannot afford to buy a home.

If it is true that the banks now are originating more than, say, the home loan banks. I know there is something wrong. Banks, to begin with, the reason why the Congress in the 1930's agitated and finally produced the basic structure known as the home loan bank systems, which incidentally was really created during Herbert Hoover's administration with that aim in mind, to allow for some availability of housing.

But it was actually Mr. Hoover's program, the home loan bank systems. Then, with the advent of the deterioration of the economy and with the intense desire to allow the average American family to keep his home and not lose it—to whom? To the banks. You had the deposit insurance systems created and the other supporting mechanisms.

Now, before the war started you had the additional FHA implementation, which in effect was what later the SBA was intended to do and that was provide every little businessman access to credit below the market interest rates.

It seems to me that he might have the statistics tending to show that, yes, X number of units have been disposed of one way or the other. But we don't have the true picture; that is, the average American family is priced out of home ownership at this time.

There are differences. Our country is three or four times bigger than it was in the 1930's. Demographic changes have been tremendous, dramatic. The size of families in the urban areas who want home ownership has gone to lease-holding or renting, not home ownership.

The Congress has not recognized that as such. We don't have any national legislation addressing the rights of tenants or dwellers. When it will, God only knows, but I think it will come only after social stress. We cannot for long continue to have the housing crisis this Nation has now without ultimately paying a price in social dislocation.

You don't have to be a prophet to know that. If anybody is in touch with folks whether in the rural, in dense urban areas and/or in between, where you still have the bulk of the home ownership areas, the problem is very severe. I think the reason is that if we are going to depend on the banks to originate more home mortgages, we are lost, but any time a bank has a chance to make on 1 percent interest more on anything else, that is what it's going to go, so that if they are originating more home mortgages, it is because, obviously, something is happening here. I think what it is is independence.

Mr. EVANS. Yes, the spreads are pretty good.

Chairman GONZALEZ. That's right. Now, in an attempt to try to provide a mechanism in place of that which has crumbled around

our ears, though we still don't admit it, I advanced and lo and behold it was accepted in the housing bill last year, the national housing trust approach.

We had a very specific target, first-time homebuyers, but we had to cap interest rates. We had understandings with the administration and those on behalf of the administration with respect to that. It did become a part of the law, thank goodness, but with the interest rate cap which, I think, is the only way we will ever have any kind of a modicum of relief as far as home availability to every American family, not just the wealthy or the in between, but everybody, will be when we can control that interest rate.

The long-term fixed, 30-year mortgage which made it possible, the miracle of the ages because between 1940, more or less the inception of FHA, and 1980, the United States did something that no other nation has done in the 20th century.

It housed its people, so that if you look at what happened after 1982 and the emergence of this very distressing thing known as homelessness, you have cause and effect. You cannot abandon the national commitment to housing without having something.

So in an effort to do that, what I thought was that we would have the use of the S&L's because they are in place. They are a system that has experience in mortgage transactions and FHA and capping the interest rate. We could, with a minimum, with investment equal to about the cost of construction of about four or five B-1 bombers, make a dent in this problem.

So as I see it, the use of the mechanisms I saw in working the reality, eventually you have a national trust was the thrust of these mechanisms, in other words, preserving the experience of the home loan banks and FHA. They are in place.

The thought was suggested by one or two academicians that some new structure be put in place. But I could not see why, if we had these that are experienced and have the knowledge that is in place now, why we could not use them.

To me, it is very disturbing. I would still like to know when someone on your staff can get us the statistics on what is the average size of the mortgage that the banks are financing.

Mr. EVANS. Mr. Chairman, your comments are entirely accurate. I am sitting here smiling. When I was a senior in law school, I applied for a mortgage at a bank where I had my checking account. I was making $1,000 a month and I was turned down without explanation.

Because I had a little bit of clout, I found out they were not making any mortgage loans that year. So I could have been making $125,000 a year and I would not have gotten the loan. You are right. The problem that we face is that the industry we serve is in fact shrinking and you see that in the performance of the Federal Home Loan District Banks is where it has shrunk the most.

We have some areas where the advances in that district account for less than 4 percent of the funding in the district. One would argue the recommended advance of that particular district bank.

We have others where they count for one quarter of the mortgage funds. One doesn't need to argue the relevance. We need to tweek, twitch, shave and mold it to 1991 just as the chairman has tried to do through the national housing trust.

We feel the responsibility to see to it that our dollars go for housing and that the implied taxpayer guarantee, which keeps our cost of funds low, somehow works its way through to benefit the mortgagor. This subcommittee has made it clear that they consider our primary mission housing.

You know the reason is substantial and sometimes a little abstruse to try to understand.

Chairman GONZALEZ. You are a lot younger than I am. I don't know what the time period was when you applied to the bank.

Mr. EVANS. The recession of 1974–1975.

Chairman GONZALEZ. By that time you had the corrosive interest rate aberrations.

Mr. EVANS. They said I could have a loan at 16 percent.

Chairman GONZALEZ. In 1967 I was able, at a percentage rate of a little less than 6¼, in February 1967, I obtained a loan by getting what, to me, was a substantial downpayment, and through the bank, because the interest rates—I thought it was very high that I had to pay 6. Less than 5 years later, the home that I entered into a contract to buy in 1953 for $7,000, I had an offer for $14,500. So I knew something was wrong.

The house I bought in 1967 on a 15-year mortgage, and finally paid it out in 1982, and in the late 1970's, early 1980's, I was offered $225,000. I bought this house——

Mr. EVANS. Let me know where you are going to buy your next house.

Chairman GONZALEZ. It is an old neighborhood. It is about 75 years old—no central air or heating, but I got it for $13,000 in 1967. In less than 7 years I was offered $225,000. You know something is dead wrong, that you were getting into a very, very speculative atmosphere and of course this is what we are paying for now.

I certainly agree with you and I am delighted to hear of your approach and we want to compliment you. We are going to address your recommendations.

Mr. EVANS. When I was last here I was asked for a report on community commercial banks. We have done that, which might answer part of your question with respect to the lending practice of the smaller community banks that have a more direct connection with the home mortgage markets and the smaller communities they serve.

I appreciate the opportunity to be here.

Chairman GONZALEZ. We in turn are grateful to you for your cooperation and the time you took out to be here on a Friday morning.

I apologize for the lack of membership present today. Sometimes the quality of two members can make up for the absence of others.

Mr. EVANS. I have no testimony on that subject.

Mr. KENNEDY. You don't?

Chairman GONZALEZ. I shouldn't have said anything.

Anyway, thank you very much.

Mr. EVANS. Thank you.

Chairman GONZALEZ. Our first panel consists of Mr. Stephen Ashley, member of the executive committee of the Mortgage Bankers Association of America and the president and chief executive officer of the Sibley Mortgage Corp. of Rochester, NY; Mr. Rick

Adams, chairman of the Conventional Mortgage Committee of the National Association of Realtors, and president, Independent Mortgage Services of San Antonio; and Mr. Paul Barru, chairman of the Standing Committee on Mortgage Finance of the National Association of Home Builders, of Littleton, CO; Mr. David F. Holland, chairman of the Federal Home Loan Bank Task Force, and chairman and chief executive officer of the Boston Federal Savings Bank of Burlington, MA, on behalf of the U.S. League of Savings.

I will ask our colleague Mr. Kennedy to introduce him when we get to his place.

If there is no objection, why don't I recognize you in the order that I introduced you. None of you has a time problem.

Mr. Ashley, thank you for being with us and thank you for your statement. I don't know if that was Burton Wood with you earlier.

STATEMENT OF STEPHEN B. ASHLEY, CHAIRMAN OF THE LEGISLATIVE COMMITTEE, MORTGAGE BANKERS ASSOCIATION OF AMERICA, AND CHAIRMAN AND CHIEF EXECUTIVE OFFICER, SIBLEY MORTGAGE CORP., ROCHESTER, NY

Mr. Ashley. Burton Wood is here. It was Mike Ferrell with me, Mr. Chairman, when I was introduced to you.

Chairman Gonzalez. You may proceed as you deem best.

Mr. Ashley. Mr. Chairman, Mr. Kennedy, thank you very much for the opportunity to be here.

My name is Steve Ashley. I am chief executive officer of the Sibley Mortgage Corp., headquartered in Rochester, NY. I am serving as MBA's legislative committee chairman. We appreciate the opportunity to appear before you today to testify regarding H.R. 2900, which seeks to increase the financial safety and soundless of Fannie Mae and Freddie Mac.

MBA supports adequate capitalization for FHLMC and FNMA, as well as appropriate regulation of their continued safety and soundness. However, capital and regulatory requirements should also be sensitive to their housing mission. Such requirements should also be clearly related to specific risks associated with the different types of mortgages, investment securities, and guarantees provided by FHLMC (Freddie Mac) and FNMA (Fannie Mae).

MBA believes that in light of the types of risks incurred by the agencies and their ongoing strategies for controlling interest rate and credit risk, excessive capital requirements are not necessary and, in fact, would limit credit availability and raise interest rates for homebuyers.

MBA urges a measured response that will establish appropriate capital standards that adjust with dynamic changes as they take place in the market or with the development of new products.

In attaining mandated capital requirements, FHLMC and FNMA should strive to preserve mortgage credit affordability. Fees and charges to seller/servicers should bear a direct relationship to the risk of the type of mortgages purchased or guarantees provided.

We believe that HUD is the most appropriate regulator, if HUD is provided sufficient support to give it the capacity and expertise to perform this job credibly. We believe that HUD has the "will" so long as it is given the resources to have the "way." We believe as-

sessments against FNMA and FHLMC should fund program monitoring and oversight.

HUD understands the housing support and mortgage credit role that these corporations fulfill. HUD should be given the financial management support necessary to monitor and evaluate FHLMC and FNMA and to enforce requirements necessary to ensure that FHLMC and FNMA maintain their financial soundness and their ability to play a meaningful role in providing housing and mortgage credit.

MBA supports regulatory reviews and enforcement powers to ensure safety and soundness to protect taxpayers from the potential of any Federal expenditures on behalf of these corporations arising from any implicit guarantee. The business operations of FHLMC and FNMA should be monitored and subject to examination, audit, and enforcement actions.

However, this regulatory control should be sensitive to the necessity of these corporations to operate flexibly in fast-paced financial markets. The ability to innovate and create new mortgage programs to meet ever-changing consumer needs should not be stifled.

The stark reality of our ongoing budget deficits has put tremendous pressure on the government's ability to dedicate adequate resources to housing and has resulted in the reining in of programs to enhance mortgage credit opportunities for Americans. The role of FHLMC and FNMA will be even more important in the years to come.

The statutory changes to FHA that were enacted last year in the housing bill will, in MBA's opinion, seriously erode the role that FHA has historically served, which was to ensure a stable supply of low downpayment mortgage insurance for low-, moderate- and middle-income borrowers, particularly first-time homebuyers.

We believe that recent statutory changes taken in tandem with HUD's aggressive regulatory interpretations will weaken FHA's effectiveness as a tool to help deliver affordable mortgage credit.

We hope that FHLMC and FNMA will be able to enhance their role in ensuring stable supplies of affordable, low downpayment mortgage credit that the private mortgage insurance industry will provide the necessary backstop to FNMA-FHLMC's purchase and securities programs.

Likewise, in the area of multifamily mortgage credit, HUD's active role has been significantly diminished. FNMA and FHLMC with their sophistication and market presence can and should ensure that a market exists for soundly underwritten multifamily projects as well, including those projects that would serve low- and moderate-income families.

In the last year there has been an increase in the number of tax credits gone unused because of the lack of availability of mortgage financing. This problem has been particularly acute in Michigan, California and has affected Massachusetts. The Boston Capital Group and the Boston Financial Group have specifically been unable to complete tax credit deals because of the lack of financing.

H.R. 2900 requires the HUD Secretary to give written, prior approval to any new program. MBA is strongly opposed to this expansive power, because we believe it will stifle innovation and can be

used to further political or philosophical objectives that have nothing to do with safety or soundness considerations.

So long as FNMA and FHLMC are healthy, they should be free to initiate programs that respond to rapidly changing markets and economic environments. We believe that the risk-based capital requirements will serve as adequate controls on new products where the potential for risk, due to lack of market experience, is a concern.

MBA supports the risk-based capital requirements contained in this bill. We are particularly pleased to see that specific statutory factors are included for determining risk-based capital.

However, MBA opposes the undefined discretion of OSMEO to increase the add-on component covering operations and management risk. We believe that the 20 percent add-on requirement already anticipates a cushion for risk. At a minimum, standards for the exercise of a discretionary increase should be clearly delineated in the statute.

MBA believes that strong capital requirements are necessary to protect the government from contingent liability. If those capital levels are being achieved, however, we believe quite strongly that interference in day-to-day operations, program and financing decisions, et cetera, should be left in the hands of the management and boards of the entities.

MBA opposes the cap on salaries, but supports language requiring that salaries be "comparable" to other similar businesses. FNMA and FHLMC are large, sophisticated corporations, which must be able to pay competitive salaries in order to attract and retain top flight talented employees.

MBA supports the requirement that FNMA and FHLMC must devote a "reasonable portion" of their single-family and multifamily mortgage purchases to low- and moderate-income families.

MBA believes that one of the primary housing affordability concerns today is the difficulty that first-time homebuyers have in accumulating savings for a downpayment. We would urge that stimulating homeownership for this target group should be a specific goal.

Lack of available multifamily mortgage credit, particularly for low-income projects, is a serious problem today, particularly for older properties.

FHLMC has been out of the multifamily market for over a year, although they are gearing up for a new program. This has had a devastating impact on multifamily mortgage financing.

FNMA, while it has remained in the market, has fairly stringent underwriting guidelines which tend to favor newer projects.

HUD has only begun to implement its delegated processing program and so its activities are confined primarily to full insurance HUD processed loans.

The problem is not so much one of lack of equity, but the lack of financing avenues. There are instances today of low-income tax credit projects that are not being closed, because of lack of available financing.

The bill mandates an affordable housing program funded by FNMA and FHLMC at a level of 20 percent of their previous year's dividends.

MBA opposes this particular solution for several reasons.

First, the program would be funded as a tax on homeowners, who are the ultimate source of FNMA/FHLMC revenues.

Second, and most importantly, the program would not result in significant levels of funding for multifamily housing.

We believe that more units would be produced, even for the needy families targeted by this proposal, with an affirmative requirement to finance a specified number of units.

MBA strongly believes that FNMA and FHLMC must shoulder the burden of enhancing housing opportunities, as well as enjoy the benefit of profitably ensuring stable supplies of mortgage credit.

We would welcome the opportunity to work with the subcommittee in devising methods to ensure a strong commitment by FHLMC and FNMA to affordable multifamily rental housing and to innovative programs, particularly for first-time homebuyers.

Although there are concerns with H.R. 2900, MBA believes that the proposal represents a measured approach that can accommodate the dual objectives of safety and soundness with the public mission to promote housing affordability and mortgage credit availability.

We believe that a capital-driven and growth-constrained business will invest only in gold-plated product, which is not the public policy mission Congress conferred by charter. FNMA and FHLMC are unique in that they were chartered as private companies with public missions. This broad service to American families, which has worked well and has earned strong, continuing support from policy makers, housing advocates, and homebuyers would be discontinued if safety and soundness concerns were followed without concern for the public mission of FNMA and FHLMC.

MBA appreciates the opportunity to testify before this subcommittee and will provide answers to questions or requests for additional information, if needed.

[The prepared statement of Mr. Ashley can be found in the appendix.]

Chairman GONZALEZ. Mr. Adams.

If you will yield to me, I understand you are from San Antonio?

Mr. ADAMS. Yes, I am, sir.

Chairman GONZALEZ. Let me welcome you aboard, as a fellow San Antonian, and thank you for appearing here. I think you are here on behalf of the realtors. I want to thank you and all our friends back in San Antonio.

STATEMENT OF RICK ADAMS, CHAIRMAN OF THE REAL ESTATE FINANCE CONVENTIONAL MORTGAGE COMMITTEE, NATIONAL ASSOCIATION OF REALTORS, AND PRESIDENT, INDEPENDENT MORTGAGE SERVICES OF SAN ANTONIO

Mr. ADAMS. Thank you. I was going to begin by offering a San Antonio "buenos dias" to you and Mr. Kennedy.

My name is Rick Adams. I am a realtor from San Antonio, TX, and the chairman of the Real Estate Finance Conventional Mortgage Committee. On behalf of the approximately 780,000 members of the National Association of Realtors, I am pleased to have the opportunity to present this association's views on legislative pro-

posals designed to enhance the financial safety and soundness and ensure the continued viability of Government Sponsored Enterprises (GSEs), specifically the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). This legislation provides an excellent start for legislation on Government Sponsored Enterprises, specifically Fannie Mae and Freddie Mac.

As a preface to my discussion regarding H.R. 2900, the association requests as the subcommittee considers this legislation it do so within the context that we are not in the same place and time as we were in August 1989. In 1989, Congress just enacted FIRREA to save the crisis-riddled thrift industry and its depositors at a starting cost of $50 billion.

At that time Congress' concern that GSE's contingent liability of $800 billion represented the next financial crisis to the taxpayer mandated several studies be done to determine if they were indeed safe and sound. As part of the Omnibus Reconciliation Act of 1990, both Houses of Congress passed resolutions calling for the consideration of legislation to regulate GSEs by September 15 of this year.

Today, the benefit of seven studies confirms that Freddie Mac and Fannie Mae are financially healthy and strong even under the most stressful conditions. We believe any legislation should be guided by these conclusions.

Moreover, any legislation must balance and not sublimate the GSE's national housing mission with the legitimate safety and soundness concerns. Regulatory intervention should be early enough to prevent losses to the American taxpayer.

However, where a GSE is adequately capitalized, regulatory inclusion should be kept to a minimum and should not interfere with the day-to-day management or decision making of those entities.

Mr. Chairman, we believe your legislation embodies a reasonable and sound approach to GSE capitalization and regulation. Your proposed regulatory oversight framework is workable.

We recommend certain provisions be fine-tuned to accomplish the desired results. First, we support the incorporation in the bill of a specific risk-based test. We believe Congress and not the regulators should make the determination.

A statutory stress test also provides clear parameters in which to evaluate the GSE's performance. We oppose provisions which would permit the regulator to alter the capital levels for management and operations risk.

Second, we are opposed to provisions which would permit the new director to require additional capital when new programs and products are offered even after the GSE has demonstrated its adequate capitalization on the application of these stress tests.

The association believes this represents an unnecessary level of regulatory intrusion which will hinder the development of special housing products.

Third, we support provisions in your legislation which would place the new GSE safety and soundness regulator within HUD. We would go one step further and recommend the safety and soundness regulator and the program regulator be one and the same.

Mr. Chairman, the National Association of Realtors supports the activities and public policy mission of the federally chartered secondary mortgage markets operation. Their rule is crucial and necessary in the home mortgage finance system. Federal oversight of GSE activity is most proper and necessary.

We commend you for your thoughtful approach and proposed solution to the issue.

This concludes my oral statement. I would certainly be welcome to answer any questions the subcommittee may have.

[The prepared statement of Mr. Adams can be found in the appendix.]

Chairman GONZALEZ. Thank you, Mr. Adams. That is very efficient of you. Your entire statement, which was I think very complete—I wanted to compliment you on that—will be in the record following your oral testimony. I wanted to thank you for it. It was very good, very appropriate.

Mr. ADAMS. Thank you, Mr. Chairman.

Chairman GONZALEZ. Mr. Barru.

STATEMENT OF PAUL BARRU, CHAIRMAN, NATIONAL ASSOCIATION OF HOME BUILDERS, MORTGAGE FINANCE COMMITTEE

Mr. BARRU. Mr. Chairman, I am Paul Barru. I am a home builder from Littleton, CO. I am here representing the National Association of Home Builders, and currently serve as the chairman of their Committee on Mortgage Finance.

I want to thank you for the opportunity to make remarks in addition to our written statement, and share a few thoughts to make to highlight our concerns.

First of all, we are very pleased that you have taken the leadership in introducing H.R. 2900, which on balance we think is an admirable approach to the issue of GSE financing.

On the other hand, we are very nervous every time a new piece of legislation comes out. We have memories of unintended consequences that have occurred over the last decade since we began tinkering with the thrift operations in 1979, changing tax laws in 1979, 1980 and then 1986 with a devaluation of real estate values, and then the FIRREA legislation.

There are usually unintended consequences that occur if people work too fast. I heard you say that to a group of us from the home builders who have visited you in chambers at the time the FIRREA legislation was going through, that you were concerned we were working too fast and had not thought through the consequences.

Chairman GONZALEZ. Will you yield to me there?

You are right, of course, we live in a day and time when you have a problem, so you do one of two things. You either pass a bill and you get the bill passed, and then everybody says we solved the problem, or you have a constitutional amendment or try to work towards a constitutional amendment as if that is going to solve it.

There were very fundamental things that I was hoping we would address 2 years ago and not be rushed into a quickie resolution at just the S&L level. I felt—and I still do—and I think events now prove that we were bound to look into the overall reform of what has turned out to be called the deposit insurance system.

My contention was that the big mistake was that everybody was dealing with the S&L as if it was in an orbit all to itself where, as you know, out in the world you are competing with many other financial activities. Unfortunately, we didn't see it that way.

Structurally, the other reason I felt we were acting too fast was the bill the President sent us first in February would provide, for instance, RTC, a three-member board to consist of the Attorney General, the Chairman of the Federal Reserve Board, and the Secretary of the Treasury. I couldn't understand that. So we had to fight like dogs to finally get the Secretary of HUD to be placed on that board.

I felt that to allow the FDIC Chairman to wear two hats was not good. I didn't think, given the tremendous overhang of the REO office out there that RTC would be dealing with, that the track record of the FDIC indicated they had any kind of experience in that area.

I think events have shown that the two hats Mr. Seidman has tried to wear has led to some very serious problems. But these are things that in retrospect nobody remembers. I am grateful to you for remembering that I was.

I have always said that fast government tends to be dangerous government. It is the same thing here today. You know, we are under the gun because other members—in fact, in the tax-writing committee wanting to exercise jurisdiction over these entities as well as others in other committee jurisdictions did impose on the budget resolution language a requirement that this be looked into and some action be forthcoming this year.

That doesn't necessarily mean that I succumb to being stampeded, but we are in good faith proceeding expeditiously. You are right. I, too, shudder when I think of the processes. We can start something, but we don't know where it is going to end because you have to go through the amendatory process, you have got to go to the full House, you have to work with the Senate and then have a conference.

I want to let you know that I deeply appreciate your memory there and also that I hear the sense of misgivings. Yet, we have to face it, and we will do the best we know how.

Mr. BARRU. Thank you.

Let me continue on that track because basically we feel that in the face of a major credit crunch in the United States, the one area that has not suffered any shortage is mortgage finance. That is because we have a functioning GSE system. Fannie Mae and Freddie Mac has filled the gap when other elements in the arena of housing finance have fallen by the wayside and failed to pick up their share of the load.

The thrifts have diminished in their role. The banks have diminished. From my point of view, there is an old adage. If the system isn't broke, don't fix it. Provide preventive maintenance.

Preventive maintenance is oversight for capital adequacy. Preventive maintenance is making sure they fulfill their proper public policy role. If you start imposing new major requirements on a system that is working when the rest of the financial system is having trouble fulfilling the requirements of housing in America, I worry about the unintended consequences.

Truly, I want Fannie Mae to continue to provide money for low-cost housing. I want Freddie Mac to get into that market.

Housing affordability is a major issue from our association's point of view. But to impose a quota, we don't know what the consequences of that will be in the affordability quotient of all other mortgage finance. We are really more interested in seeing this occur by a constant monitoring and an encouragement of increasing their role in that rather than establishing a quota at any given point.

The second point we would like to make is we would like to see the total housing finance system addressed at once. That means banks, banking reform. That means the Federal Home Loan Bank Board. That means the GSE system. To separate them and to treat them individually is to do a disjustice to housing finance.

Our major problem right now is not mortgage finance. Our major problem right now is the ability to produce housing. It is housing production money. Unfortunately, people who are in the housing business are viewed by Wall Street, by the banking community, and I am afraid by many Members of the Congress as being in the real estate business.

I would like to give you an analogy. Automobile makers are not viewed as being in the steel business because the primary product that they use in making their automobiles is steel. We use land to produce lost upon which we build houses. That doesn't mean we are in the real estate business. It means that real estate happens to be the raw material of our business.

We need credit to provide money to build homes. We would like to have this subcommittee and the Congress of the United States examine some of the recommendations we have made to broaden the powers of the Federal Home Loan Bank System in two specific ways.

One is to provide for their involvement in the entire spectrum of housing finance. The production of lots, the construction of homes as well as mortgage financing. We would argue that that part of the thrift problem was a very insignificant part of the total REO problem that RTC and FIRREA was addressing. Therefore, we think it is something that, prudently done, can enhance the role of housing and needs to be looked at.

Second, we are concerned that mega-banks will not deal with the typical homebuilder. Therefore, the Federal Home Loan Bank System really has to make a level playing field to allow small community banks to begin to fill the role of thrifts that have failed in many, many parts of the country and left many communities without thrifts to provide the traditional role of the housing lender in that community.

We think that if this legislation can be looked upon as part of a whole package that addresses not only mortgage credit, but housing credit in its fullness, that it will serve the concern that the chairman and other members of this subcommittee have classically addressed. That is the housing affordability and availability quotient.

Thank you for the opportunity to make these few comments. I will be glad to answer questions. Obviously, I appreciate the attention you have given to our full written report.

Chairman GONZALEZ. Thank you.

Again, as in the case of the other witnesses, your prepared text, which again I compliment you for, is very full, complete, will be in the record. I want to thank you.

[The prepared statement of Mr. Barru can be found in the appendix.]

Chairman GONZALEZ. Mr. Holland.

STATEMENT OF DAVID F. HOLLAND, CHAIRMAN, FEDERAL HOME LOAN BANK TASK FORCE, AND CHAIRMAN AND CHIEF EXECUTIVE OFFICER, BOSTON FEDERAL SAVINGS BANK, BURLINGTON, MASSACHUSETTS, ON BEHALF OF THE U.S. LEAGUE OF SAVINGS INSTITUTIONS

Mr. HOLLAND. Thank you, Mr. Chairman and Congressman Kennedy.

My name is David Holland. I am Chairman and Chief Executive Officer of Boston Federal Savings Bank, which is a $550 million SAIF-insured savings bank——

Chairman GONZALEZ. Excuse me. Will you yield to me? I neglected to ask Mr. Kennedy to introduce you. You may be a constituent. I don't know. Forgive me for not calling him.

Mr. KENNEDY. Thank you. You effectively introduced Mr. Holland earlier in the day. He happens to be the Chairman of the Federal Home Loan Bank Task Force, and the present Chief Executive Officer of the Boston Federal Savings Bank from Burlington, Massachusetts. He is not a constituent unless he happens to live in the congressional district. Burlington, at least at this stage of the game, is not part of my district. On behalf of—which could change in the next few months.

In any event, we look forward to hearing your testimony, Mr. Holland. I appreciate you coming down from Boston to inform us today. Thank you.

Thank you, Mr. Chairman.

Mr. HOLLAND. Thank you. Thank you, Congressman Kennedy.

I appreciate the opportunity to be here. To begin with, we want to commend you and the other sponsors of the proposed Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991. We believe it is essential that the Nation develop a new framework for dealing with the housing GSEs.

We believe your proposals set the stage for the development of that new framework. In particular, we want you to know that we strongly support your efforts in two areas: Promoting safety and soundness, and promoting low- and middle-income housing.

During my testimony today, I want to address the major areas of this proposed legislation. We believe your proposals are essential, and headed in the right direction. We do believe, however, that the proposals don't go far enough, and would like to see them strengthened.

We also would like to briefly address the issue of the Federal Home Loan Bank System. As you know, the future of the Federal Home Loan Bank System is of vital interest to the thrift business. As Chairman Evans commented on in his testimony, he is absolutely correct that the remaining segment of the thrift industry is very

profitable, is very successful, and has a relatively strong level of capital which is increasing every day.

We need the Federal Home Loan Bank System to continue our commitment to housing, including the affordable housing component.

We strongly support the efforts in the proposed legislation to increase the availability of financing for affordable housing and to improve the safety and soundness of the GSEs.

With respect to affordable housing, we support the provisions to improve the targeting of Freddie Mac and Fannie Mae lending to low- and middle-income families. We applaud the definition of these groups. We suggest that the Congress determine in this statute the appropriate percentage of these entities' lending that should go to families in need.

We believe this percentage should be significant and that it should be increased over each of the next several years.

In addition, we endorse the efforts to include Fannie Mae and Freddie Mac in the affordable housing effort. We believe that the 20 percent of dividends figure would be roughly equal to the amount now being contributed by the Federal Home Loan Banks, and would be even lower when tax-affected. We would hope that provisions could be added which provide for this percentage to increase comparably with the scheduled increases in the Federal Home Loan Bank Program.

With respect to capital, the U.S. League believes that all financial institutions, including the housing GSEs, need strong capital and aggressive supervision. The debacle of the 1980's has taught us this lesson all too well. We support the application of the current international risk-based capital rules to Fannie Mae and Freddie Mac and to the Federal Home Loan Bank System.

Further, we support the CBO's contention that there should be capital requirement equity between the three housing GSEs, Fannie Mae, Freddie Mac and Federal Home Loan Banks. Thus, we would urge the subcommittee to reevaluate this issue.

Finally, the thrift industry views the future of the Federal Home Loan Banks as vital to its own future. Although the Federal Home Loan Bank System remains strong, there are valid concerns about its future. The Bank System has been shrinking along with the thrift business. This has not been a problem in the past, but it is now, with the passage of FIRREA.

In the past, the system was able to expand and contract effortlessly in response to changing demands for advances.

Now, as the system shrinks, the $300 million lump-sum annual fee paid by the Bank System for REFCORP becomes an increasingly untenable burden. We urge that this fee be changed from a lump sum to a percentage of income basis.

We do not agree with those who suggest the changes are reason for panic. We do not support suggestions that the Bank System should get into new, risky activities to boost its earnings. Neither the capital our institutions have invested, nor the taxpayer, should be at risk by banks getting involved in such activities.

We also are very concerned about proposals to change commercial bank membership and stock purchase requirements. We believe that the current system is fair, given existing mandatory

membership and thrift QTL requirements. The current membership system is disadvantageous to SAIF-insured savings institutions, since they must belong to the Federal Home Loan Bank System, and are forced to purchase stock from the system, even if they don't borrow from it.

Savings institutions are denied access to the Federal Home Loan Bank advances if they fall below the test. We support a leveling of the playing field by making all membership in the Federal Home Loan Bank System voluntary. We believe the advantages of belonging to the Bank System, the access to liquidity and the long-term advances for housing loans will cause a great majority of our institutions to continue their membership.

The Boston District Bank, to which I belong and of which am also a member of the board of directors currently, is a real-life laboratory to study the effects of voluntary membership. In my District, about 70 percent of the institutions belong voluntarily and show no inclination to cease being members.

If we can achieve voluntary membership for all members, we believe stock purchase and other membership requirements should also be the same for all members. We vehemently oppose, though, any change unless the voluntary membership is granted to savings institutions.

Once again, the U.S. League of Savings Institutions strongly supports the subcommittee's efforts. We want to thank you for this opportunity to make our views known. I would be pleased to respond to any questions you may have or to supply additional information to my oral and written testimony.

Thank you very much.

[The prepared statement of Mr. Holland can be found in the appendix.]

Chairman GONZALEZ. Thank you for your prepared text. Again, I thought it was very detailed and very good, very helpful.

On page 5 of the prepared text that you gave us, Mr. Holland, you say Fannie Mae's and Freddie Mac's capital levels not only give them a huge competitive advantage over private firms, but also an advantage relative to the Federal Home Loan Bank System, which contains equity as a percent of total obligations equal to 7.5 times that of Fannie Mae and almost 12 times that of Freddie Mac.

It is more or less what our first witness said earlier today. But I was going to ask Mr. Ashley if he had any comment on that observation, and the assertion that Fannie Mae and Freddie Mac are unfair competitors in that respect over the thrifts, and if that impacts or affects mortgage financing?

Mr. ASHLEY. Mr. Chairman, I would be glad to comment. Certainly in our prepared testimony and my spoken testimony, we indicated that we felt that Fannie and Freddie, because of their congressional charter, enjoy a very unique situation in the capital market housing—housing capital market structure that exists in the country today.

However, I would tend to reject the idea that the playing field is unlevel. The thrift and banking industry enjoys benefits of deposit insurance that I think tend to level that field. I would ask the sub-

committee to be cognizant of that as we balance my colleagues' testimony with our thoughts.

Chairman GONZALEZ. I didn't bring that up with our first witness. We had this statement, written statement—and I placed it in the record—we need the RTC Board, but the industry advisory committee that FIRREA mandated for the SAIF insurance fund sent us a letter saying they would be insolvent in the not-too-distant future, so we are having problems there.

You do bring up an important aspect, which is the deposit insurance guarantees of full faith and credit of the government. In your statement, you express some concern about FHA being able to continue, at least in an active role, to finance adequately housing mortgages, home mortgages and the like.

Could you enlarge on that? You know, that was our big debate last year in the case of the Housing Act. We still have a great deal of concern. We have not obtained the reports earlier this year that we were hoping we would get in order to see, for instance 57 percent requirement announced by the formulation of the regulations which I have expressed disagreement with.

But, nevertheless, it was implemented that way. So, I am very much concerned and want to know if perhaps you have some statistical or other knowledge about this danger that FHA may not be in a position to do the job that it ought to be doing.

Mr. ASHLEY. Mr. Chairman, I can only share with you our industry's deep concern about the ability of FHA to continue its mission of serving particularly first-time homebuyers. I would cite specifically the Housing Act that you referenced as being, in our view, detrimental to that mission.

When you have increased downpayment requirements, have removed the options of the higher level of loan value ratios, you have made the monthly cost to the homebuyer higher, you raise that threshold for the first-time homebuyer.

They must have more income to qualify. They must have more cash available at closing to qualify. That indeed has happened. In my own situation, in our company, we have seen the number of FHA loans that we are able to qualify drop by between 20 and 25 percent.

That is 20 and 25 percent of the homebuying market that is now closed out from the opportunity to buy into the American Dream. We feel very strongly that corrective action needs to be taken. We also feel that there may be some opportunities for Fannie Mae and Freddie Mac to fill some of that void.

Mr. BARRU. Mr. Chairman, could I comment?

Chairman GONZALEZ. Certainly, Mr. Barru.

Mr. BARRU. The Denver market builds approximately 1 percent of the Nation's housing stock every year and originates 4 percent of the total number of FHA loans originated during the average year.

At a meeting of our local association of FHA builders yesterday, we quantified the actual cost of the new FHA regulations for the first-time homebuyer on our typical threshold home.

It raised the downpayment $1,500 per homebuyer and it raised the income requirement by $2,000 of annual income. We feel that that is going to take somewhere between 20 and 30 percent of the

first-time homebuyers out of the qualifying market by virtue of the new regulations.

This was being discussed as part of the additional HUD regulations that are coming out on energy efficiency that we think will again only make the problem more serious for the first-time homebuyer. It is another place where we are saying people are doing one thing here and another thing here, and they are not looking at the whole picture.

We are rapidly, with these actions, eroding the affordability of housing for the first-time homebuyer.

Chairman GONZALEZ. The implementation of the act is what we have been concerned with, and the percentage requirement, 57 percent. We objected strenuously. However, at the time what we did was reach some form of compromise.

I had suggested something, but it was rejected mostly because I think OMB sat down on their territory. I had both of our minority ranking Members on the subcommittee and full committee with me on it. What we did, we cut right below the budget. It never accounted for this $1,500 downpayment figure—your upfront cost there.

So it is a matter of considerable concern to us, and that is the reason I was raising the issue.

In anticipating some of the witnesses we will have on the third panel with respect to the need for Fannie Mae and Freddie Mac to develop more flexible underwriting criteria to meet the needs of the low-income community, do you believe that this type of change would increase the availability of mortgage credit in urban areas and in low-income communities? I will ask that of any member of the panel because you are all out there.

Is there some conclusion to be reached that that would be a likelihood of attainment?

Mr. ADAMS. Mr. Chairman, I think that Fannie and Freddie's past track record as far as housing to all areas, the affordable housing issue I think proves itself that they are constantly innovating. Again, one of the big benefits of entities such as Fannie Mae and Freddie Mac is their ability to innovate new market products to respond to certain market needs. I think we can look at their past record and think that will continue.

They are constantly reevaluating underwriting guidelines to try to target certain areas such as the affordable housing areas, initiatives they are taking with Michigan and other State and local housing agencies' programs that they are trying as far as pilots go to see if something more sustained could be adapted.

I think, quite simply, suffice to say that is one of their focused missions, is to innovate and develop new programs to deal with those segments.

Chairman GONZALEZ. Mr. Barru.

Mr. BARRU. Mr. Chairman, one of the basic problems of what I am perceiving to be a tiered underwriting system that favors low-income housing for Fannie Mae is the requirement that they have low downpayment mortgages insured.

The private mortgage insurance industry becomes a part of the safety factor for their operation. That industry is not willing to

insure. The role of FHA has been precisely to insure the higher risk mortgages.

What is happening when we went to the periodic half-a-point that did not require anything upfront and had a working system, and everybody said all we are doing right now is putting a present value on that periodic and getting it all in cash upfront and then financing the whole thing. We changed the whole equation and had the unintended consequences of insuring unsafe mortgages by making the loan to value over the total value of the house. Therefore, when there was a walkaway, the losses to the fund were significant. You try to put that kind of an imposition without private mortgage insurance on Fannie Mae and Freddie Mac, and you are going to have the same kind of consequences.

This is what we mean when we talk about unintended consequences in asking a private sector to try to fulfill the role that the public sector was not able to fulfill because it hadn't really looked at the consequences of changes it was making.

Mr. ASHLEY. Mr. Chairman, I would like to adjust a couple of thoughts to that. It strikes me that there are perhaps some ways that Fannie Mae and Freddie Mac can be more aggressive in this area without adding unnecessarily to the risk burden. We have talked about the problems currently with the FHA Program.

We could work with your staff and suggest some changes. Perhaps some would require charter changes that would enable Freddie and Fannie to take higher ratio loans, that would enable them to use as part of the downpayment housing credits that may flow from State and local housing agents, agencies, this type of thing. Could work with them and your staff on the guidelines for community renewal areas where there is a need for housing credit to flow.

I am particularly concerned about the multi-family program. I referenced that in my spoken testimony. We need multi-family financing more than we need multi-family credits right now to make that flow of capital and new construction work.

We have good programs presently in Fannie Mae. They tend to favor newer properties, larger properties. We are concerned with the concentration of the flow of that credit through lenders.

We feel strongly they need to keep an active, viable program that will tend to keep multi-family credit moving into the smaller communities that may not be served by dust lenders. These are thing that I think address the question that can be positive and work toward the issues that we are concerned on and the affordability issue.

Mr. HOLLAND. To also respond, I think that relaxing or reducing the underwriting standards would, in fact, make housing more affordable. But we have to, I think, be very careful and strike a proper balance between making housing more affordable and the risks of lowering underwriting standards because Freddie Mac and Fannie Mae are backed by the full faith and credit of the U.S. Government.

One maybe more effective way to provide low-cost housing is a program in place now by the Federal Home Loan Bank System which is the Affordable Housing Program which reduces the interest rate. The standards remain the same, but the rate gets reduced in order to accommodate low- and moderate-income housing.

That has been done very effectively.

Also, it goes beyond just the rate, too. Rate is only a small portion, I think. The real issue is the cost of housing. Banks are willing to participate and do their fair share with the encouragement of Congress.

We are willing to continue to do that. We have to look at other ways to make housing affordable.

One last comment regarding the deposit insurance comment that Mr. Ashley made with regard to a level playing field. I guess I would have a slightly different point of view. I would say that the member banks of the Federal Home Loan Bank System, by virtue of paying for deposit insurance, puts them at a competitive disadvantage because it is an additional cost that have to incur that, in fact, gets ultimately passed onto the consumer.

Freddie Mac and Fannie Mae enjoy all the same guarantees of the full faith and credit, but they don't have to deal with the deposit insurance premium. They don't have that cost. I would have a different point of view on that subject.

Mr. ASHLEY. I respect Mr. Holland's different point of view. Fannie Mae and Freddie Mac do pay taxes, I would add.

Chairman GONZALEZ. It is interesting, Mr. Holland. You referred to the fact that both Fannie Mae and Freddie Mac have the full faith and credit of the U.S. Government, that they are fully guaranteed. Well, there is a great dispute about it. I was interested to see your statement or assertion in your opinion that they do have that. There is a big controversy over whether it is an implicit or explicit guarantee or what have you.

I think the fundamental thing there is that from the beginning once the idea was carried out to provide this type of activity through the help, as small as it might be, of the government in the market place that what we have is quasi-public or private, whichever, point of view, enterprise.

But to what extent that means that the full faith and credit of the government is involved is a question that there is quite a bit of argument about. But I was interested to see that you are of the mind that that is so.

Mr. HOLLAND. I appreciate that distinction, Mr. Chairman. I would add in the concept of too-big-to-fail, used in connection with commercial banks primarily, I think might also apply to Freddie Mac and Fannie Mae.

Chairman GONZALEZ. That abomination, I have challenged that from the beginning since 1984. The first time that was really announced was in the case of the Continental Illinois by Chairman Volcker. There is nothing in the law that sanctions that anymore than there was anything or is anything in the law that says that uninsured shall be paid out as if they were insured.

There is nothing in the law. Research that.

But it took 1 year before I finally had a referrence to what it was the FDIC was referring to, and it was almost the same language and it was in a very limited context, statutorily speaking, as the Home Loan Bank Board had in its decisions in entering into these arrangements, such as the Southwest plan and then the December blizzard of 1988, and they are very tenuous.

You know, the fact is that how could an entity such as a Home Loan Bank Board, or for that matter, the Chairman of the Federal Reserve Board, or for that matter, the Chairman of the FDIC or RTC in entering these arrangements, how could they do that which the President can't do and the Congress can't do? That is, they have to have an authorization and an appropriation upon which an appropriation shall be made, according to the discussion.

When you look at what it is that these regulators have usurped, it is the language in another context that says that in making these attempts to resolve the problem of insolvency, that every effort should be made to do it at such a cost as would reduce exposure of the insurance fund.

Well, that is hardly the Congress delegating the power to authorize and appropriate, which I think is a nondelegable function anyway.

Nobody has seen fit to question that and I couldn't persuade anybody. In 1984, I was the only one asking that the Chairman have hearings, and they weren't about to. In the meanwhile, it is here and it is one that is sinking.

It is sinking the ship. There is no question of it. There is no—there is going to be no end if we continue the way we are. It is a bottomless pit, but I don't think that the perception is here yet. What I am afraid of, and I really shudder to think that what's involved is a very shapeless and detrimental psychological thing which, in essence, means loss of confidence. Our whole system is based on trust and confidence.

The whole banking system, the financial system, everything. When that goes and when the people know, and we have been trying to say—I have been telling the chairman of the FDIC, and, in fact, in 1984 when Chairman Volcker appeared before the subcommittee and I had 5 minutes, I asked that question. I said, well, do you intend to do in the case of any other substantial bank You mean you are going to do everything, use all the resources and the power and whatever it is you have in the way of money at the Fed, and he said absolutely.

He said, "I will use every single resource of this country." Now that is in the record. It is in the testimony. Nobody pays attention to it. What I am saying is that at this point how can we tell the people that with just in the commercial banking industry, you have no more than $3.7 trillion in insured deposits and a broke insurance fund.

How can you tell the people that the full faith and confidence of the United States is behind that $3.7 trillion when that exceeds the national debt? So you don't have to have all that, that is true. But we have never had an actuarily sound—and this is a predicament that I think spills over and affects every level.

Like it or not, you are in that market and you are affected. But it seems to me that we have goten away so far from basics, just plain old-fashioned basics. I can't see how proceeding the way we are we will have anything but just an endless—when we are pushed on FIRREA, we were reminded every day by the administration that every day the Congress took to resolve this, you would have a $20 million drain per day. But it is still there.

In fact now it is more than per day because the methods have not changed any in the resolution. You still have long term conservatorships that are costing every day. So we have our problems. You know, looking at it from this standpoint we have to look at it overall. How, it impacts.

Like FHA, the Secretary reports that he is facing 80,000 foreclosures a year and that the insurance fund has reached a point of actuarial danger. Given those facts, you have again a very tenuous situation. But in any event, I want to thank you very much.

I have one last question that I will submit in writing and it has to do with H.R. 2900. I will tell you what it is so you can give it some thought. That is, if you think the capital requirements such as we have explained them in H.R. 2900 would result in higher mortgage rates and if so, do you have an idea as to how much.

I don't expect you to answer that now. But please do it sometime soon. The staff will check with you. We will take you up on your offer, Mr. Ashley.

Mr. ASHLEY. Thank you, sir.

Chairman GONZALEZ. Mr. Kennedy.

Mr. KENNEDY. Thank you.

I thought it was interesting that you all sort of agreed with the portion of the Chairman's bill that requires 20 percent of the dividends from the GSE to go toward the low-income housing program was something that you did not support.

You also argued that both Fannie and Freddie are doing a great job already.

Mr. Barru, you indicated that there was no credit crunch in mortgaged financing because of the GSE's continued ability to provide liquidity in that market. That might be true in some sort of general matter but it is far from the truth for low- and moderate-income people. They have suffered tremendously as a result of not only the credit crunch but from the outright decreases in the amount of funds that the Federal Government has provided for low- and moderate-income housing. We have seen, as the Chairman has pointed out on a number of occasions, 10 years ago the Congress spent much more money on affordable housing in real terms than it does today.

Even the GSE's themselves have really in some cases been abandoned, particularly multi-family housing. We have seen almost a complete abandonment by Freddie and a dramatic decrease in multi-family housing financed by Fannie Mae. It seems to me that all of us, I am sure, Mr. Holland, that you are very well aware and I saw in your testimony, the needs for the support for low- and moderate-income housing in particular.

It seems to me that—you are talking about an organization that has a 35 percent rate of return on equity. You have an organization that seems to be doing extremely well in the market these days, that if we look at any of the analyses that is made available to the public it would appear that even on Fannie's own judgments that they have become more, I think they refer to them as "plain vanilla" types of mortgages. We have seen an abandonment of the higher risk.

I know from my experience in dealing with Boston banks the difficulties that they have, even with people who were paying 40 to 50

percent of their incomes in rent, in buildings that they could own, but getting those loans approved by either one of the organizations because of the rigid requirements by those organizations in terms of the kinds of mortgages that they will lend, we have seen as evidenced by the next panel and their testimony will indicate that there has been continued evidence of discrimination in the secondary market against poor minority and inner city areas.

I guess the real question is, I know you have indicated the goal is the same of getting these organizations or the needs, rather, of getting needs addressed of low- and moderate income people and these housing needs, that is after all why the GSE's exist to begin with. Not, as we have heard in short debate, there are plenty of thrifts and others that would be out there providing the kind of assistance that is now provided through the use of at least some kind of government assistance through these GSE's.

So it seems to me the real question is whether or not the kind of minimum effort that is being asked in this bill to support—I mean I think this would end up being something in the neighborhood of $50 million out of organizations that loan $300 billion a year worth of mortgages which I think is a piddling amount to be honest with you.

Maybe you have a problem with the mechanism used but it seems to me that it is incumbent, if you are going to criticize the mechanisms that the chairman and the subcommittee has come up with in the mark, than to come up with your own mechanisms to indicate how other than some nebulous promises which is what we have gotten so far out of Freddie and Fannie, that they are going to come up with a way to achieve the goal for low- and moderate income people, people of color, people in the cities, with the kind of mortgages they need in order to be able to deal with the rising cost of housing in so many areas across the country.

That is my basic question. Maybe each of you could answer it briefly.

Mr. ASHLEY. Congressman Kennedy, let me assure you that my testimony did not, I hope, leave the impression that we were opposed to the concept of commitment of Freddie and Fannie to financing low- and moderate-income housing.

Mr. KENNEDY. No, you didn't, just to the 20 percent.

Mr. ASHLEY. The mechanism proposed in H.R. 2900 we object to for several reasons. If the goal is to increase the number of low- and moderate- income units that are financed, it seems to us that to be specific, put into the legislation, affirmative requirements that we would be glad to work with the subcommittee on developing——

Mr. KENNEDY. How would you do that?

Mr. ASHLEY. You could have specific goals, percentage of the units. I think you could do some work in terms of how low- and moderate-income is defined.

Mr. KENNEDY. You would say that a percentage of all the housing units——

Mr. ASHLEY. That would be one approach. I think our suggested solution would be to deal with specific affirmative targets that could be identified. Further, and this goes really to the mechanism, Mr. Chairman, we think that using the leverage capability, the fi-

nancing capabilities which of course is the strongest thing that Freddie and Fannie bring to the market rather than an equity or the grant capabilities as the 20 percent suggests, will finance more units.

That is the objective.

Mr. KENNEDY. Do you think that you and I should get the Mortgage Bankers Association to back the notion of taking a set percentage. I mean other than single digit percentages of all the GSE's into low- and moderate-income housing?

Mr. ASHLEY. Yes, sir, I do.

Mr. KENNEDY. That is terrific. Let's see if we can work on that. I am delighted to hear that. Maybe we can hear from some of the other panelists as well.

Mr. HOLLAND. Yes, I would be glad to respond.

In my testimony not only does the U.S. League and its membership and myself personally support the 20 percent but we would even recommend that that be increased over time.

Second, the definitions with regard to who shall qualify and the median income levels suggested in the bill, we support. I also go one step further along the lines of a recent dialog here that a percentage of units be dedicated to low and moderate incomes.

Mr. KENNEDY. What kind of percentage?

Mr. HOLLAND. In the 20- to 30-percent range.

Mr. KENNEDY. Do you have a sense of where they are today?

Mr. HOLLAND. No, I don't.

Mr. KENNEDY. Do any of you know the position of Freddie in low- and moderate income units percentage?

Mr. BARRU. Freddie is not low. I would like to stop using Freddie and Fannie as hyphenated words. They are two different organizations which have different charters and they were not chartered to serve low- and moderate-income people. They were not. Freddie Mac was established to provide liquidity to the thrift industry. It was to take a glutted industry that did not have capital adequacy to provide a sufficient number of market rate mortgages to the country and to provide liquidity by being able to package those into securities and sell them to the capital markets.

That is where the term secondary market came into existence, through the creation of Freddie Mac.

Mr. KENNEDY. You also understand the purposes of thrifts was to serve the low- and moderate income people of this country. That is why the government came in and provided the implicit guarantee that exists. That is why they get as the testimony indicated yesterday, something in the area of $4 billion a year worth of subsidy.

Mr. BARRU. Let's not get into why they were chartered but address the 20-percent issue.

You are saying $50 million is a pittance. The fact of the matter is that because of the shrinking capability within the thrift industry to portfolio loans, there has been an increase in the demand of the services of Fannie Mae and Freddie Mac to continue to provide liquidity to the depository insurance institutions and package their mortgages which have a leverage ratio of 50 percent under the Basil agreement into securities that are packaged by Fannie and Freddie and can be bought back in as investments, a leverage ratio of 20 percent.

Mr. KENNEDY. Why is that inconsistent with serving low- and moderate-income people?

Mr. BARRU. It is not but the reason they have been able to grow and still be sound financing, is to be able to reinvest a great deal of their profitability into enhancing their capital stature so that their leverage ratio doesn't grow.

Mr. KENNEDY. They have not. They have grown phenomenally and their capital is less than 1 percent. Don't tell me their capital is so fine today. These are organizations that get 35 percent rates of return and they don't put their money back to where it should.

They are not serving the poor. They are not providing the kind of assurance that GAO says—these organizations are in deep trouble. I am not suggesting that is necessarily the perspective I have. I don't think it is accurate to suggest that somehow or other that we, as a result of the strength of these mortgages, ought not to be directly serving the needs of the low- and moderate-income people who it is my opinion that they perceive some measure of government support in order to achieve.

Mr. BARRU. All I am saying is that I don't think you can put an arbitrary percentage on. We are not disagreeing with your desire at all. We share the same desire. We think there is a tremendous gap in money that is being made available for home ownership in moderate- and low-income people. We think there is a total absence of serious commitment to rental housing that is affordable in this country for low-income people.

We have been crying about it. Historically that has been handled through FHA and not through Fannie Mae and Freddie Mac.

Mr. KENNEDY. What would you do, sir?

Mr. BARRU. I think if we got back to the issue of providing programs like we did through the 1970's that really had the ability to provide a great deal of low- and moderate-income housing through FHA we would not be talking about $50 million which is not going to address the issue.

Mr. KENNEDY. Putting the money back in is a very different question than the ones we are asking in terms of whether or not Fannie Mae and Freddie Mac ought to be putting in some percentage. It is not the most radical notion in the world.

You have two or three members of your own panel that indicate that they would support the concept. To tell you the truth I think it goes farther than the subcommittee is dealing with. So I don't think this is exactly a radical concept we are dealing with.

Mr. BARRU. All we are saying is we are worried because we have watched before unintended consequences of arbitrary numbers that have been taken in or taken out of financial legislation in the last decade that have had dramatic consequences that are not anticipated.

We would like to see an urgency placed on getting Fannie and Freddie back into affordable housing, particularly in the rental market.

However, we don't want to see an arbitrary number put in legislation that will impact them over a set period of time. We would rather see some targets.

Mr. KENNEDY. We have heard the numbers of the mortgages for low- and moderate-income people, people of color and people in the

inner city is at a bear minimum. Their own testimony, their organizations testify they are getting into plain vanilla mortgages. Nobody in the Congress wants to get involved in these issues.

They only have to get involved when the organizations get away from the central purposes and missions for which they were designed to fulfill. That is what has happened. It has happened only in terms of the mortgages. It has happened in terms of the compensation packages and right down the line.

That is why these hearings are being held. I appreciate your perspective. We should leave this up to the market or some voluntary approach on their part. They don't do it. That is why we are here.

Mr. Adams.

Mr. ADAMS. Congressman Kennedy, I wanted to add some perspective and some analysis that we have done. Our concerns on that stem from the fact that we have a very fragile capital and financial market right now. It is very likely that comments we made regarding impositions of restrictions on Fannie Mae and Freddie Mac could be moving the stock as we speak.

In 1990 Fannie Mae invested $1 billion into the housing, and Freddie Mac, $220 million into the housing mission. Thirty percent of the loans purchased by Freddie Mac were affordable by families earning 80 percent of the median income. Between now and 1987 when the company created a separate office for low- and moderate-income housing, Fannie Mae provided $5 billion in financing commitments to serve approximately 90,000 low- or moderate-income families.

In 1991, they have announced an initiative to provide an additional $10 billion commitment by July 1993 to serve 190,000 families. I refer to the past track record. I think we have to look at that. My colleagues have mentioned their ability to attract capital. That is something to be aware of.

The money they have to invest in the housing mission is a sign of the funds they can attract and the safety and soundness investors perceive of Fannie and Freddie.

They have made more than $2 billion in commitments in community lending programs to provide 6 percent downpayment loans on favorable terms. Another statistic that is important, since 1987 Fannie Mae purchased $2.8 billion in mortgage revenue bonds from State and local housing finance agencies which allowed them to offer tax exempt financing to lower cost on low-income mortgage that would not otherwise be possible.

We have a demonstrated track record. Putting a percentage in there, 20 percent or others, I think may be a little arbitrary. They have demonstrated a commitment to that. Obviously, the National Association of Realtors holds the needs for the low- and moderate-income borrowers, as well as the affordable housing issue to be of utmost concern.

I have been reminded that most recently there has been a collision between the U.S. Conference of Mayors and an 11-city demonstration program with Fannie and Freddie that will also go a long way toward providing some of these well-needed funds.

Mr. KENNEDY. I don't question the $3 billion of the combined outfits that you cannot come up with a few billion dollars worth of examples. I would be surprised if you disagreed with the fundamental

facts I gave in terms of decline overall in multifamily, the decline in the inner cities, the decline in terms of the number of mortgages to moderate income people, working people in this country, and particularly minorities and people of color in our country.

These are the issues that we are talking about. I am not suggesting that they don't have some good innovative and creative programs.

The question is whether or not on a percentage basis, of all the huge growth we have seen in these organizations, whether or not they are not in fact pulling away from the higher risk, more difficult mortgages, getting into competition with institutions that could normally provide the same kind of financing that they do and in fact evolving into organizations that provide a tremendous rate of return, provide a hell of a lot of good salaries for the very top people in the organizations, provide a rate of return at 35 percent and put the taxpayer on the hook because they have 1 percent capital. That is what they have done.

Mr. ADAMS. You made the comment that their investment in these categories are nebulous. I guess the figures show in the past it was not a nebulous amount.

Mr. KENNEDY. I think you can be specific about some demonstration programs, which you have been. I would not have that the overall level of funding that you have referred to in comparison to the overall amount of funding these organizations provide is that significant.

Let me ask Mr. Holland if he had a comment. He indicated he did.

Mr. HOLLAND. Thank you, Congressman. This is to partially respond to a question you asked earlier and along the lines of this discussion. Perhaps the real dollar amount of commitment of Fannie and Freddie have increased in recent years, but percentagewise, I am not sure that is the case.

On page 9 of my written testimony, I said, "In our view the great success of these entities has not resulted in their efforts to aggressively serve lower and moderate income borrowers as Congress mandated. Instead, they have taken over the middle of the housing market which can be served by the private sector. Over the past 6 years the agencies have increased loan limits by 66 percent while the median selling price for homes has gone up 26 percent."

That does not conclude my statement, but it certainly leads one to think more dollars, percentagewise, are going to higher income than lower income homebuyers.

Mr. KENNEDY. Thank you.

Chairman GONZALEZ. Thank you, Mr. Kennedy.

Unfortunately Mr. Ashley had to leave. But Mr. Ashley, in his statement, categorically stated that he was against the cap we placed on compensation.

I just wanted to point out that in his opinion, we do have a cap. I was going to ask him to explain to you why it is a cap.

Mr. KENNEDY. The mortgage banker would consider that a cap, sure, Mr. Chairman. It is the difference between their cap and the kind of cap I think we should be putting on these institutions, Mr. Chairman.

Chairman GONZALEZ. Well, I think we have held the witnesses here long enough, perhaps too long.

In any event, thank you very much for your help and your patience.

I ask unanimous consent that the letter from Peter Treadway of the Research Division of Smith Barney, Harris Upham and Co., Inc., be placed in the record.

[The letter referred to can be found in the appendix.]

The next panel consists of Mr. George Butts, who is the President of ACORN Housing Corporation in Philadelphia, PA; Mr. Terrence Duvernay, President, National Council of State Housing Agencies, and Executive Director, Georgia Housing and Finance Authority; and Bart Harvey, Vice Chairman, the Enterprise Foundation of Columbia, MD.

We want to thank each and every one of you again. I say again because you have been, in relation to the subcommittee, constantly helpful in keeping us informed.

If there is no objection, I will recognize Mr. Butts, and each one thereafter in the order that I introduced you.

Mr. Butts.

STATEMENT OF GEORGE BUTTS, PRESIDENT, ACORN HOUSING CORP., PHILADELPHIA, PA

Mr. BUTTS. Thank you, Mr. Chairman.

Mr. Chairman, my name is George Butts of ACORN Housing Corporation in Philadelphia. I am here representing the 80,000 nationwide low- and moderate-income members of ACORN, the Association of Community Organizations for Reform Now.

ACORN has neighborhood chapters in 26 states and has successfully negotiated over 25 Community Reinvestment Act bank agreements representing more than $500 million in targeted loan commitments for low-income home ownership.

On behalf of ACORN, I wish to express our thanks for your leadership in saving the CRA. The struggle gave me more gray hairs in my period than normal.

While it is important to note that CRA is alive in the statute, we are dismayed to report to you that CRA is being strangled by the business practices of Fannie and Freddie at the grassroots. Merely preserving the status quo with respect to CRA demands a real overhaul of these publicly chartered and subsidized institutions.

We have been successful for the most part in changing the way the banking community views and deals with the low- and moderate-income community.

We have made major changes in underwriting criteria, helped to establish counseling programs, held major events to bring banks and communities together.

All this has helped to develop over $9 million in loans for low- and moderate-income families in Philadelphia last year.

It has taken us 5 years to get what we have now. It has not been easy. Our experience has shown that the secondary market bears more than its fair share of responsibility for stopping many lenders from understanding and supporting the wisdom of what we are

trying to do, to accommodate the economic realities of low- and moderate-income neighborhoods.

We have met with Fannie Mae several times. We do not want to diminish the work that they have done, but it is clear they are not doing the kind of thing they can do to fundamentally change the impact of the secondary market on the low- and moderate-income community.

Overall they have taken the path of least resistance; and in our written testimony, we have made several recommendations to help assure that community lending is a viable option for local financial institutions.

First, Fannie Mae and Freddie Mac should be required to set aside a portion of their annaul profits for an affordable housing program like that at the Home Loan Banks. These funds could be used to help the agencies purchase below-market loans and to facilitate agency assistance to lenders for origination of below-market loans for single and multi-family borrowers. Second, no less than 30 percent of mortgage purchases by Fannie and Freddie should be from borrowers of less than 80 percent of the area median income. Third ,these agencies must establish antidiscrimination policies.

These agencies should be barred from purchasing loans from any lender who discriminates on the basis of race and gender, Fannie and Freddie must use their enormous influence in the market to encourage lenders to use nondiscriminatory underwriting standards. And if banks fail to comply after proper warning, they should be cut off from doing business with Fannie Mae and Freddie Mac.

Negotiating underwriting standards with the banks we have relationships with in Philadelphia, I can talk with first-hand experience about that. They have done a stellar job in trying to do this kind of business with low- and moderate-income people.

Sitting at the table with Fannie Mae people a few weeks ago, it struck me that they seem to be at the place that the banks were 4 or 5 years ago, where we were still haggling over basic things like underwriting and accepting below-market rate mortgages and using market clout.

This was very frustrating for us. At this point, we have seen things work. We know what can happen when people have the commitment to make low- and moderate-income lending programs work. We also know that there is only so much banks can do when they are strapped with the secondary market to deal with.

There are only so many loans that these banks will keep in their own portfolios. Banks must be able to sell low-income loans if we want to expand the availability of low-income housing.

To summarize, my main problem with Fannie Mae and Freddie Mac is that their underwriting criteria discriminate against low-income people. They are not dealing with the basic obstacles that they create to the provision of low-income affordable housing..

[The prepared statement of Mr. Butts can be found in the appendix.]

Chairman GONZALEZ. Thank you very much.

Now, in your statement, which I again compliment you on, you say each time ACORN has appeared over the years before the subcommittee or the full committee, it seems to me they do a tremendous job of research and then do a good presentation. This will

appear as you gave it to us in the record following your oral remarks.

Mr. Duverany.

STATEMENT OF TERRENCE R. DUVERNAY, PRESIDENT, NATIONAL COUNCIL OF STATE HOUSING AGENCIES, AND EXECUTIVE DIRECTOR, GEORGIA HOUSING AND FINANCE AUTHORITY

Mr. DUVERNAY. Thank you, Mr. Chairman. I would also like to thank Representative Kennedy.

My name is Terry Duverany. I am executive director of the Georgia Housing and Finance Authority but I also serve as President of the National Council of State Housing Agencies. Today I am testifying on behalf of the NCSHA and within that organization I chair a task force of State finance agencies that has recently been organized to meet regularly about Fannie and Freddie to discuss making their programs more relevant to low-income people.

We appreciate this opportunity to testify on your legislation H.R. 2900 which was designed to improve the financial safety and soundness of Fannie Mae and Freddie Mac, particularly with regard to mortgages for the Affordable Housing Program. We commend you for recognizing that these important institutions can and should do more to provide affordable housing to low-income Americans.

Measures in support of Fannie Mae and Freddie Mac, Freddie Mac's safety and soundness need not be inconsistent with their congressionally-mandated public purpose. We believe the proposed affordable housing program that has been contemplated would go a long way toward meeting the affordable housing mandate, even while strengthening the capital posture of the corporations.

We applaud Fannie Mae for all that it has done in affordable housing. We also commend Freddie Mac for hiring Carl Riedy, former executive director of NCSHA, to establish an affordable housing department within Freddie Mac, and for hiring Dwight Robinson, who was deputy director of the Michgan State Housing Authority. We ask that they encourage Fannie Mae to continue and expand its current level of effort in affordable housing.

It requires Freddie Mac to expand its portfolio as fast as practicable to a level comparable to Fannie Mae. The new housing program must be in addition to and not a substitute for these important efforts. Fannie and Freddie's affordable housing initiatives have not been targeted so far to the income levels required under the Affordable Housing Program for multi-family programs or indeed to the still unmet needs in the single-family area.

Fannie and Freddie's programs operate understandably to underwrite conventional untargeted housing. Unfortunately, many affordable housing projects cannot meet these standards for reasons that do not necessarily include risk.

A affordable housing program such as your legislation recommends can address the needs of these low-income housing projects which do not meet conventional underwriting standards. The proposed affordable housing program establishes the necessary framework for the development of an alternative product line to meet the unique circumstance of low-income housing. We strongly sup-

port the concept and offer the following specific suggestions that the AHP be improved .

Number one, the AHP should be designed to require Fannie Mae and Freddie Mac to undertake low-income housing activities beyond those permitted by their present underwriting standards. It should not be a grant program for a relatively few projects scattered across the country. Instead, program funds should be retained within the corporations to leverage financing for targeted, low- and very low-income housing programs not presently undertaken by these corporations.

Two, the AHP should include a low-income single-family component for otherwise nonconforming low-income loans which gives preference to areas, such as rural areas, where rental housing is frequently not viable.

Three, Fannie Mae and Freddie Mac should be required to devote a meaningful amount of funds to the AHP based upon some measure of their profitability. We are not certain that a percentage of dividends, as the legislation proposes, is the best way to measure the level of effort required in the new program.

Other measures might include net earnings, some combination of net earnings and dividends, or even some significant portion of their overall secondary market activity which was clearly required to be committed to the kind of projects we are describing in this testimony.

Whatever measure the subcommittee determines is appropriate should result in a minimum of $1 billion in leveraged financing for low-income housing under the new program.

Four, the subcommittee should take care to ensure that the AHP addresses unmet housing needs and is not permitted to be a substitute for Fannie Mae's present level of effort in affordable housing or what we hope will be Freddie Mac's expanded effort in affordable housing or what we expect will be Freddie Mac expanded efforts and a commendable move.

In that direction, if I might for a moment expand for a little bit on the Affordable Housing Program concept and structure. As I mentioned earlier I think the Affordable Housing Program should require Fannie and Freddie to establish a separate alternative product line.

Programmed funds could be used for a number of purposes including loan loss reserves, operating loss reserves, subordinated loans or loan guarantees for deeply targeted projects. The principal goal should be to provide acquisition, construction and permanent financing including secondary financing to low-income rental properties that meet the legislation's recommended income targets.

A portion of the program should be devoted to financing single-family loans that do not conform to the underwriting criteria of the corporation's present Affordable Housing Program. Such presently noncomforming loans include community reinvestment account loans which must be held in portfolio by banks, reducing the amount of lending they can do.

Given the comparatively larger need for low-income multi-family we however on the single-family side think any fund should be restricted to 25 percent of the total.

The success of the Affordable Housing Program in meeting its goals will depend on the establishment of underwriting standards more flexible than Fannie Mae's and Freddie Mac's conventional business. Our experience demonstrates that low-income housing which does not meet conventional underwriting standards need not, however, imply greater losses than more conventional products.

If that then proves to be the experience, the reserves can deliver even more financing and possibly lead to an expansion into conventional programs, which I think would be a good outcome of this.

We would recommend that an advisory committee be established to consult with Fannie Mae and Freddie Mac under the reality of this new program and that the subcommittee include representatives from the nonprofit community, the private sector, such as realtors and homebuilders, and State and local government.

We think that Freddie Mac and Fannie Mae should report to that advisory committee on the new program. I would like to now talk about two additional matters.

I would like to express some of what you heard before, but something that we share. We share a deep concern about two provisions of the bill not directly related to affordable housing proposals. First is the requirement in the proposed legislation that Fannie Mae and Freddie Mac must obtain HUD's approval before the introduction of new products.

Nothing in the recent experience suggests that this requirement is justified. We believed it will needlessly chill the development of affordable housing and other initiatives. It would subject it to the vagaries of a process that could stifle the innovations we are trying to encourage.

We believe the Democratic requirement would be time-consuming, counterproductive, and we think it should be dropped. We think the HUD authority to revise Fannie Mae and Freddie Mac's pricing decisions is too broad and should be reconsidered.

Mr. Chairman, in closing, let me suggest that housing finance agencies have faced the same challenges as Fannie Mae and Freddie Mac, that we currently face in delivering affordable housing. We believe we have a lot to contribute to the development and implementation of the program.

We offer the subcommittee our assistance and we offer it also to Fannie Mae and Freddie Mac in carrying it out. I thank you for allowing us to appear before you to make this testimony.

Chairman GONZALEZ. Thank you for an excellent statement.

[The prepared statement of Mr. Duvernay can be found in the appendix.]

Chairman GONZALEZ. Mr. Harvey.

STATEMENT OF BART HARVEY, VICE CHAIRMAN, THE ENTERPRISE FOUNDATION, COLUMBIA, MD

Mr. HARVEY. Thank you, Mr. Chairman, and members of the subcommittee. It is a pleasure to appear before you. I am Bart Harvey, cochairman and chief executive officer of The Enterprise Foundation, which is a publicly-supported, nonprofit organization which works across the country with over 130 nonprofits in 70 cities pro-

viding decent, affordable housing in some of the most distressed neighborhoods in this country, to some of the lowest-income people in this country.

Before making comments regarding specific aspects of this bill, I would like to comment on The Enterprise Foundation's experience with Fannie Mae and Freddie Mac, and our understanding of their mission and performance.

Taking language from FIRREA in 1989, Fannie Mae and Freddie Mac now have similar charters and purposes—and I am summarizing—to provide stability in the secondary market for home mortgages, to respond appropriately to the private capital market, to provide ongoing assistance to the secondary market for mortgages, and I note, "including low- and middle-income mortgages involving a reasonable economic return," and to do this by increasing liquidity and improving the distribution of investment capital, to help fulfill this Federal charter and its attendant public purpose, Fannie Mae and Freddie Mac were given access to an implied guarantee of the Federal Government.

Now, there is no debate that these companies have succeeded magnificently in expanding the base of investors, in bringing stability to the markets, in standardizing the terms and being in the national mortgage markets in good times and bad.

I note the Southwest on that. More importantly, they have passed most of their Federal benefit through to the ultimate consumers, which have helped millions of low- and moderate-income homebuyers.

By Fannie Mae's own statistics, over 30 percent of their loans were made to low- and moderate-income families and the mortgage amounts were under $57,000. We need, Mr. Chairman, far more disclosure to know exactly to whom all of these loans are going.

We should give credit where credit is due. Over the past 5 years, Fannie Mae, and more recently since the charter changes in 1989 for Freddie Mac, both of these entities have concentrated major efforts on nonconventional markets.

These are very hopeful steps that both entities have made. But they need further development. We need to make sure that deliverables meet the commitments that have been outlined.

Fannie Mae introduced a very bold $10 billion program in single and multifamily mortgages to assist 180,000 low- and moderate-income families. Freddie Mac has recently undertaken a $100 million multifamily program with the nonprofit LIMAC and are reentering the multifamily market.

I would like to return to those areas later.

Specifically, regarding proposals in your bill, we are very concerned that your proposals bifurcate safety and soundness from the public purpose mission of these entities. The creation of the Office of Secondary Market Examination and Oversight solely to administer safety and soundness, we think, is a dangerous step.

We have found in other agencies, such as the Office of Controller of the Currency, that one side implements stiff risk based premiums, especially on multifamily housing which serves the poorest, while the other side of the agency, citing the Community Reinvestment Act, encourages these same lending institutions to make

loans that are no longer financially viable or in their best interest from a capital point of view.

Last year before subcommittees here, Treasury wanted Fannie and Freddie to be triple A which would largely have negated the benefit of the implied Federal guarantee and would have made them less willing to extend themselves to public service programs or reaching low-income people or taking on any loans that might have perceived risk or to have experimented with programs for low- and moderate-income Americans.

We believe the Office of Examination and Oversight must be balanced with the objectives of the public purpose mission of these two entities.

We also view as dangerous a provision that the director of his office can arbitrarily set a capital level for management and risk over a 20-percent requirement. That would be easy for the director to do, to have a very conservative capital structure, but we find conservative capital structures inevitably hurt low-income Americans.

Furthermore, to capitalize on the innovation, speed, adaptability and the experimentations of these entities and their ability to fashion pilot programs that could lead to new systemwide programs for low-income people, we hope that all affordable housing programs would not need prior approval to be carried out. We say this in the interest of timeliness. We say this in the interest of the ability of these agencies to experiment with their programs, to find acceptable loan losses in certain programs.

Finally, turning to the Affordable Housing Program, we think you have given very important recognition to a key need that is not being served in the multifamily rental housing arena.

We, however, would approach it very differently because we fear as written the Affordable Housing Program is too circumscribed in scope. It would favor a limited few. The minimum could become a maximum. It makes meeting low-income housing needs a charitable act. It does not get to the creativity, the innovation, the force and the leverage and the power of these financial institutions to do more.

We would propose instead, first of all, much better disclosure by both entities by type of mortgage, by product line, by particularly the income served of the family and the areas served which are in the central city areas.

We would recommend an annual report by volume of loans in each of these various types and products, and anticipated volumes for the coming year for existing products and for new products taking advantage of the Affordable Housing Program of RTC or the new home legislation.

We think it is very important that these entities show the deliverables against their commitments in each volume line.

Finally, we would recommend that there is an annual discussion of these entities regarding any complaints as far as perceived unfair underwriting or fair housing practices. They should sit down and go over with whoever feels that they are being unfair in underwriting or fair housing practices.

Finally, we would recommend that the new Office of Management Supervision set up an internal risk capital fund for these

agencies that is properly accredited and incentivized to have them explicitly take risks to develop new prototypes for low-income single and multifamily loans that can be developed for systemwide use.

It is The Enterprise Foundation's contention that carefully underwritten low-income housing is a viable, profitable business which can be systematically undertaken by Fannie Mae and Freddie Mac, if appropriate creative resources are dedicated to it and proper methods are employed. We commend you and these entities for what they have done.

We look forward to important new advances.

Thank you.

[The prepared statement of Mr. Harvey can be found in the appendix.]

Chairman GONZALEZ. Thank you, Mr. Harvey and thank you for your very well presented suggestions and recommendations.

I notice you agree or concur with some of the prior witnesses that seem to be skeptical about having a fixed 20-percent figure of regulatory capital determined along the risk-based criteria. I think it is something that we do have to evaluate very carefully. There was one thing, though, because I think in a way you made sort of a referral but not as directly. You say on page 3, "In tandem with Fannie Mae's and Freddie Mac's servicing of low- and moderate-income individuals through the conventional market are the specialized activities of both entities to meet the need of low-income families which do not qualify for conventional financing."

I believe it was Mr. Duvernay, in your statement, I think you make a very, very significant point here that we tend to forget about or overlook. I am going to read from page 4, "Fannie Mae's and Freddie Mac's strength lies in their ability to package large numbers of single family loans that conform to the same basic standards.

"The wholesale nature of the secondary market contributes to its efficiency, though apparently low cost of corporation and consummate profitability.

"Unfortunately, almost all low-income multi-family projects and some single family programs do not conform to the wholesale standard. Such non-conforming housing is sometimes presumed to be more risky than housing conforming to conventional secondary market standards.

"The experience of the housing standards with low-income housing shows well-structured and non-conforming projects have a good track record. The problem is that few multi-family projects have the same characteristics. They require original review and analogy, something that Fannie Mae and Freddie Mac are probably not presently equipped to provide. Fannie Mae and Freddie Mac, whose business is essentially wholesale, may need assistance regarding a volume of retail such as low- income multi- and single family programs."

I think that is a very perceptive and pertinent point here. Do any of the others—first I will ask Mr. Duvernay if he wishes to enlarge on this or if he has a supplemental statement.

Mr. DUVERNAY. I think it stands for itself. I appreciate your pointing it out, Mr. Chairman.

We understand that agencies like Fannie Mae and Freddie Mac, which are, while large and significant corporations, have become as good as they are based on their attention to do what I have described here as a wholesale side of the business. They would have to become much too large and create the kind of expertise that they are presently not here to do.

That might exist in agencies like Housing Finance Agencies. We are out there. We have to be out there in those agencies that do multi-family housing, particularly the kinds of underwriting skills necessary to look at the detailed individual projects to make sure that it works and if then packaged, could find out the way to meet a standard that could fit a program that Fannie Mae and Freddie Mac might be involved in.

That part of it, I think, is unfair to require of Fannie Mae and Freddie Mac. However, they could have partners that could do that. Just because it appears to be too risky, we think isn't a reason not to do it. It is a reason to find a way to go to and an opportunity to structure them well and to find a way to approach a problem that we heard to date has not been met even though we understand other reasons we are hearing that which suggest we don't want to meet them in a way that drives them into trouble.

This is a way to find an active way of reaching that effort without, indeed, being too risky, unsafe or unstrong. I appreciate your pointing that out.

Chairman GONZALEZ. Mr. Harvey, you, yourself, said of that, what was it, 57,000——

Mr. HARVEY. Over 30 percent of the funds reported were——

Chairman GONZALEZ. Perhaps we ought to have a little bit more information as to the exact nature.

Mr. HARVEY. We need a lot more information on exactly who that is going to.

Chairman GONZALEZ. In light of Mr. Duvernay's observation, I wanted to know what your comments would be.

Mr. HARVEY. I agree totally with what Terry is saying. That is, in fact, what we are suggesting. I think these entities are putting creative resources in finding those products which have a good loan loss experience, but they don't look like the conventional product. They should put this effort together. They should find what they can do, and they should do it across their whole system. This is really where the, quote, nonconventional pilot programs are really needed. They need to experiment and they need to find new underwriting standards that do work and are different, and they are very different for low-income people.

They need to find what kind of loan loss works and then they need to set it on a much larger scale than just in the nonconventional side of their business. Hopefully, you can marry those two and you can take some capital for experimentation. And in finding what are good loan losses and good products that just don't conform to the cookie cutter, they could do a heck of a lot more. The volume should be very large.

We believe low-income people are good credit risks. You must know what you are doing and how to create the product.

Chairman GONZALEZ. You see no impediment, though, to either one of these agencies or both being able to reach that point?

Mr. HARVEY. I think you have to sit down and set goals. I think we need a lot more information, first of all. Then you have to look at performance. I think one thing that Jim Johnson said, the CEO of Fannie Mae, is that they want their deliverables to meet their commitments. So do we.

So should all of us be working for that and to see what kind of real experience they have from putting out these commitments to do something to actually turning them into mortgages and loans.

Chairman GONZALEZ. If I may make an observation here, I am of the impression, my impression—it could be wrong—that the pressure wouldn't be on these institutions as it is, for example, in the multi-family and low-income housing if HUD had not withdrawn from that area as it has in effect. Do you feel that—in other words, I think if HUD were carrying out its program as anticipated by Congress, a lot of this pressure would be off of these secondary mortgage institutions.

Do you tend to agree with that?

Mr. HARVEY. Please don't start me on HUD, Mr. Chairman, because I think that they should be in the market. There is no excuse for them not being in the market. They should be taking risks that these entities aren't set up to take. I think you are right. Some pressure would be off of these entities in the multi-family market if that were the case. They have by their own numbers—and I am just citing their own numbers. Fannie Mae alone is 10 percent of the market and larger than the three next participants in the market.

They are in that market. I think Freddie Mac withdrew because of its loan loss experience, and it has to revamp before it re-enters. They should all be in it.

HUD should be taking the most basic risks. It is just how far you expect these entities to go and whether they should be underwriting or subsidizing certain product lines. That is the real question.

We worry the safety and soundness people always say no. You should be more conservative and have more capital. That gives them no incentive to go towards the riskier side of trying, experimenting, failing in some, but designing product that really works.

They are getting whipsawed between these two sides.

Chairman GONZALEZ. You have that tension between your safety and soundness and capital standards.

Mr. Butts, I am sorry we delayed you.

Mr. BUTTS. I feel some days I hear this stuff and I want to bust, you know. We sat down with the banks that we have in Philadelphia not too long ago, I guess 3 months ago, banks that we have relationships with, that is, Fidelity, Continental Bank, and Melon now. We raised a lot of the same issues that have been coming up here with them.

Not only us from the community side, but the banks also raised these same sort of issues. Those three banks that we have are doing these kinds of loans and through a lot of pain and a lot of change of personality. They decided to do this kind of business, but they still haven't been able to sell loans to Fannie Mae.

Fannie and Freddie aren't doing business with these banks. They are shut out of the business.

Fannie said, yes, we would love to talk to you about the problems, but nothing has happened yet. These banks have been there for 4 years doing these kinds of loans, and they have not been able to sell them to Fannie Mae. We still think there is still something fundamentally wrong with the way Fannie and Freddie look at underwriting, with the things they are willing to do. When we sat down in the room in Washington a few weeks ago with them and talked to them about this stuff and asked are you willing to go down to New Orleans where we know we have a problem with the bankers being discriminatory, banks that say they will do low-income loans and then slap a $500 origination fee to keep us out of the market, we said are you willing to come down and help us talk to these people about that, and they said yes.

Are you willing to come out and say that if you don't stop these discriminatory practices, we won't do business with you anymore? Well, they said, "I don't know. We are not supposed to be doing—we are not supposed to be dealing with anybody that is discriminatory. We don't understand what is going on here."

If I know it, and I am sitting in Philadelphia, they have to know it. I am not trying to say they are not committed. I know they work very hard. They sent me a letter yesterday to tell me how hard they work. I know they work very hard at trying to create some kind of a product, but I think they are missing the point.

The point is, they have to change fundamentally how they view low- and moderate-income folks, the same way the banks did. They have to look at us as a viable market. They have to adjust what they do to fit the market they want to serve, not the other way around, because our economic circumstances aren't necessarily going to change.

Things are getting worse for us in a lot of ways, not better. That doesn't mean we are not holding on to this dream. Home ownership is a goal for a lot of us. We don't want to spend three or four times for rent what we can pay to own. We want to make a commitment to the neighborhoods we are in. We don't want to leave.

Banks sit there and say, we would love to make this loan, but we can't because we can't turn around and sell it. And there is no point in holding it, because we are going to have to hold it for 30 years, and we don't want to hold it for 30 years. We want to get rid of it so we can get more money and do more business. And to have Fannie and Freddie say we are going to do this and make these things available, and we are going to study this and study that.

This information has been around for a long time. Any studying they had to do, I would think they could have done it by now. We provide a lot of information. We have enough background on the performance of the loans in our areas and the banks we deal with that shows we are not the risk. It is not the low- and moderate-income people that are defaulting on the loans in great numbers.

With respect to underwriting criteria that are working, it is where banks are adjusting and putting precounseling programs in place to make these deals work, where they have strong neighborhood groups out there explaining to people how important this is.

We don't walk away from loans. We are paying mortgages. My family knows if we have to get out there and sell pencils, we are

going to pay that mortgage. It might come in late, but it is going to come in, whatever we have to do. We know how important this is.

That stuff doesn't wash with me. It just gets me upset.

Chairman GONZALEZ. Properly so.

Mr. Duvernay.

Mr. DUVERNAY. The reason why we have emphasized in our testimony that there needs to be created an active product line is for merely the reasons I have just heard. Not that we—we understand there are standards that have to be conformed with. We don't want to turn any of those things around.

Unless there is a product line that has been created with the kinds of things Mr. Butts mentioned, tested and proven, all the great efforts Fannie Mae and Freddie Mac have dealt over the last several years, all the innovative and creative programs we have heard mentioned today that are part of ancillary things that they do, will never resolve the problem.

Unless we have an active product line that takes into consideration what we have heard, that becomes a standard way of operating, maintaining safety and soundness, maintaining capital requirements, unless we move to that, we are never going to solve the problem. They are integral to doing that, and that is why we have taken the position we take.

Thank you.

Chairman GONZALEZ. I am in thorough agreement. Mr. Butts, didn't ACORN develop a package in Arkansas? Did that have anything to do with Fannie Mae? Do you know? I know you are not in that area.

Mr. BUTTS. Not right offhand. I know Fannie Mae has communicated with us in the past week or so about wanting to do pilot programs in a number of cities, Philadelphia and Des Moines and Minneapolis and other cities.

Chairman GONZALEZ. A colleague told me that—I haven't been available actually to some of these executive officers in the last 10 days. It has been very hectic on the full committee level. But one of my colleagues stated that they were anxious to talk to me because they have found an accommodation with organizations such as yours; to what extent, I don't know.

What I think is this: That since—and you know, you were thanking me for whatever we did on the full committee to reverse what the subcommittee did with respect to CRA. In the first place, it shouldn't have happened, but it did.

You and I know that it is an eternal struggle. You don't win it permanently. Instead of enhancing CRA, which is in desperate need of enhancement, we were fighting to preserve what we have now and for which we fought over 20 years. We are going to have to keep on fighting.

But in the case of secondary mortgage institutions, what I have been trying to find out is a mechanism—and time has kind of overtaken me, and I haven't—if the law presently does not cover such entities as the secondary mortgage institutions, and perhaps it isn't feasible, but certainly we ought to know with what institutions they are dealing, what banks they are dealing with that are redlining, that don't have any kind of a track record or performance with CRA.

This is what I wanted to tell you that I am trying to work towards.

Mr. BUTTS. I appreciate that, because that would go a long way to help.

Chairman GONZALEZ. You are absolutely correct. We are not in the mess we are in because the poor people didn't pay their bills. It wasn't the poor people that defrauded Uncle Sam and the insurance fund and the bondholders and shareholders of all these defunct S&Ls. That is not where the S&L money was going. If it had, it would still be there with the people.

Mr. BUTTS. My wife is a very astute woman. She is also chairman of a banking committee in Philadelphia. She has through all the negotiations. We sit in negotiations together with all the banks. We hear over and over again about how low- and moderate-income people have such a high default rate, and that is why banks don't do these kind of deals. She said, When I look at the data, you are not making any loans, so where are you getting the data to say what we don't do?

Chairman GONZALEZ. The record has been there from day one. It is a constant struggle. Of course, I don't want to hold you here forever, but it has been my observation that organizations like yours and the gentleman here in their category, when the leaders won't lead, the people must push.

The track record of our government as far as anything is concerned as far as aiding and helping the masses of the people proves that it didn't come voluntarily from the governmental level. It had to be pushed into it. It took the riots and the strikes and the sit-down strikes and what we call the industrial workers organizations in the 1930's to convince Franklin Roosevelt they had a big problem. The big fear was we might get a revolution. Then is when you got social security and the other programs. But they didn't come there because it emanated from this level or the Executive Branch level. It came from the people.

This is why we are trying to keep some continuum of connection between the Congress and the people and these institutions that the Congress has created, but have reached a point where you would think they were created by divine origin.

I am not speaking of the secondary mortgage institutions necessarily. I am saying that we have vast enterprises that in effect have replaced the government as far as the basic decisions that affect our daily lives are concerned. It is the ugly truth, but it is the truth.

I wanted to thank you all because you are the ones that enable us to remind ourselves and everybody else around us why we are here. I know it is tough and I know the fight. I have been on that side years ago. Everything from schooling, adequate educational facilities, to such things as fighting discrimination in the crude and rude days. I know what you have got.

In your case, Mr. Harvey, I think you represent an entity that is very original in its approach to these problems, and we are grateful to you, too.

I have one, maybe two questions, but I can refer them to you even if we do it by telephone from the staff. But I did want to let you know that we are trying to see how we can work on where we

can at least hold to some standard or responsibility these institutions that are dealing with the banks that are not extending credit. We will see how we reach that point.

The truth of the matter is, and I have made this observation a long time ago to Mr. Maxwell, the immediate past head of Fannie Mae, the very definition of secondary mortgage institutions implies that you have a primary market.

What happens when that primary market has eroded and is gone? This is why out of sheer necessity, Fannie Mae and Freddie Mac have had to come in to a level that otherwise would have been the basis upon which they would be operating on top of that primary housing market.

Anyway, working together we will get there. I can't assure you how fast or how far, but we will try.

Thank you very much, gentlemen.

The subcommittee will stand adjourned. I want to incorporate with the unanimous consent request to include testimony, the one I had mentioned previously. We will add the National Low Income Housing Coalition's.

[The information referred to can be found in the appendix.]

[Whereupon, at 1:20 p.m., the hearing was adjourned.]

APPENDIX

July 18, 1991

I

102D CONGRESS
1ST SESSION

H. R. 2900

To improve supervision and regulation with respect to the financial safety and soundness of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal Home Loan Bank System, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

JULY 16, 1991

Mr. GONZALEZ (for himself, Mr. WYLIE, and Mrs. ROUKEMA) introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

---

A BILL

To improve supervision and regulation with respect to the financial safety and soundness of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal Home Loan Bank System, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE AND TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the "Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991".

(b) TABLE OF CONTENTS.—

SEC. 2. CONGRESSIONAL FINDINGS.

The Congress finds that—

(1) the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal Home Loan Banks have important public missions that are reflected in the statutes establishing the enterprises;

(2) because the continued ability of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation to accomplish their public missions is important to providing housing in the United States and the health of the Nation's economy, more effective Federal regulation is needed to reduce the risk of failure of the enterprises;

(3) the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal Home Loan Banks currently pose minimal financial risk to the Federal Government;

(4) such enterprises are not backed by the full faith and credit of the United States;

(5) the entity regulating the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation should have sufficient auton-

omy from the enterprises and special interest groups;

(6) the entity regulating such enterprises should have the authority to establish capital standards, require financial disclosure, prescribe adequate standards for books and records and other internal controls, conduct examinations when necessary, and enforce compliance with the standards and rules that it establishes; and

(7) while the Federal Housing Finance Board has the authority necessary to effectively regulate the financial safety and soundness of the operations of the Federal Home Loan Banks, the Federal Home Loan Bank Act should be amended to emphasize that providing for financial safety and soundness is the primary mission of the Board.

SEC. 3. DEFINITIONS.

For purposes of this Act:

(1) COMPENSATION.—The term "compensation" means any payment of money or the provision of any other thing of current or potential value in connection with employment.

(2) CORE CAPITAL.—The term "core capital" means, with respect to an enterprise, the sum of the

following (as determined in accordance with generally accepted accounting principles):

(A) The par value of outstanding common stock.

(B) The par value of outstanding preferred stock.

(C) Paid-in capital.

(D) Retained earnings.

(3) DIRECTOR.—The term "Director" means the Director of the Office of Secondary Market Examination and Oversight of the Department of Housing and Urban Development.

(4) ENTERPRISE.—The term "enterprise" means—

(A) the Federal National Mortgage Association and any affiliate thereof; and

(B) the Federal Home Loan Mortgage Corporation and any affiliate thereof.

(5) EXECUTIVE OFFICER.—The term "executive officer" means, with respect to an enterprise—

(A) the chief executive officer of the enterprise;

(B) the chief financial officer of the enterprise; and

(C) any other individual who participates, or has authority to participate, in major policy-making functions of the enterprise (other than in the capacity of a director), whether or not the individual—

(i) has an official title;

(ii) has a title designating the individual as an assistant; or

(iii) is serving with compensation.

(6) NEW PROGRAM.—The term "new program" means, with respect to an enterprise, any purchase, servicing, sale, swap, loan on the security of, or other dealing in mortgages or mortgage-related instruments that differs significantly and materially (in terms of the type of property, term of mortgage, nature of mortgage instrument, type or amount of mortgage insurance, nature of lien, form of securitization, or any other significant matter involved) from any activity or program engaged in by the enterprise on or before the date of the enactment of this Act. The term does not include any program of an enterprise approved by the Secretary of Housing and Urban Development on or before the date of the enactment of this Act, to the extent such pro-

gram is carried out in a temporary or limited manner.

(7) OFFICE.—The term "Office" means the Office of Secondary Market Examination and Oversight of the Department of Housing and Urban Development.

(8) REGULATORY CAPITAL.—The term "regulatory capital" means, with respect to an enterprise—

(A) the core capital of the enterprise plus a total allowance for foreclosure losses (including an allowance for portfolio mortgage losses, an allowance for nonreimbursable foreclosure costs on government claims, and any liability reflected on the balance sheet for the corporation for estimated foreclosure losses on mortgage-backed securities); plus

(B) any other amounts from sources of funds available to absorb losses incurred by the enterprise, that the Secretary by regulation determines are appropriate to include in determining regulatory capital.

(9) SECRETARY.—The term "Secretary" means the Secretary of Housing and Urban Development.

(10) STATE.—The term "State" means the States of the United States, the District of Colum-

bia, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, Guam, the Virgin Islands, American Samoa, the Trust Territory of the Pacific Islands, and any other territory or possession of the United States.

TITLE I—SUPERVISION AND REGULATION OF FNMA AND FHLMC

Subtitle A—Establishment of Financial Safety and Soundness Regulator

SEC. 101. ESTABLISHMENT OF OFFICE OF SECONDARY MARKET EXAMINATION AND OVERSIGHT.

Effective January 1, 1992, there shall be established in the Department of Housing and Urban Development the Office of Secondary Market Examination and Oversight, which shall be an office within the Department.

SEC. 102. DIRECTOR.

(a) IN GENERAL.—The Office shall be under the management of a Director, who shall be appointed by the President by and with the advice and consent of the Senate from among individuals who are citizens of the United States and have experience in financial management or oversight. An individual may not be appointed as Director if the individual has served as an executive officer of an

enterprise at any time during the 5-year period ending upon the appointment of such individual.

(b) TERM.—The Director shall be appointed for a term of 5 years.

(c) VACANCY.—A vacancy in the position of Director shall be filled in the manner in which the original appointment was made under subsection (a). Any Director appointed to fill a vacancy occurring before the expiration of the term for which the Director's predecessor was appointed shall be appointed only for the remainder of that term.

(d) SERVICE AFTER END OF TERM.—A Director may serve after the expiration of the term for which the Director was appointed until a successor Director has been appointed.

(e) DEPUTY DIRECTOR.—There shall be in the Office a Deputy Director, who shall be appointed by the President by and with the consent of the Senate, and who shall have such functions, powers, and duties as the Director shall prescribe. In the event of the death, resignation, sickness, or absence of the Director, the Deputy Director shall serve as acting Director until the return of the Director or the appointment of a successor under subsection (c).

SEC. 103. AUTHORITY OF DIRECTOR.

(a) EXCLUSIVE AUTHORITY.—The Director shall make determinations and take actions that the Director determines necessary with respect to each enterprise regarding—

(1) establishment under section 201(a)(4) of risk-based capital standards for risk associated with new programs of the enterprises;

(2) examinations of the enterprises under section 211;

(3) decisions to appoint conservators for the enterprises;

(4) enforcement actions under titles II and III, including any final decisions in contested administrative enforcement proceedings; and

(5) approval of payments of dividends by the enterprises under section 303(c)(2) of the Federal National Mortgage Association Charter Act and section 303(b)(3)(B) of the Federal Home Loan Mortgage Corporation Act.

The authority of the Director under this subsection shall not be subject to the approval of the Secretary.

(b) AUTHORITY SUBJECT TO APPROVAL OF SECRETARY.—Any authority of the Director not referred to in subsection (a), including the authority to issue rules and regulations, shall be subject to the review and approval

of the Secretary, but shall not be subject to the review or approval of any other officer of the Department of Housing and Urban Development.

(c) DELEGATION OF AUTHORITY.—The Director may delegate to officers and employees of the Office any of the functions, powers, and duties of the Director, as the Director considers appropriate.

SEC. 104. PERSONNEL.

The Director shall appoint and fix the compensation of such officers and employees of the Office as the Director considers necessary to carry out the functions of the Director and the Office. Officers and employees shall be appointed without regard to civil service laws and their compensation fixed without regard to the provisions of title 5, United States Code.

SEC. 105. FUNDING.

(a) ASSESSMENTS AND FEES.—The Director may establish and collect from the enterprises such assessments, fees, and other charges that the Director considers necessary so that the amount collected is an amount sufficient to provide for all costs and expenses of the Office of Secondary Market Examination and Oversight, including the expenses of any examinations under section 211.

(b) FUND.—There is established in the Treasury of the United States a fund to be known as the Secondary

Market Examination and Oversight Fund. Any assessments, fees, and charges collected pursuant to subsection (a) shall be deposited in the Fund. Amounts in the Fund shall be available, to the extent provided in appropriations Acts—

(1) to carry out the responsibilities of the Director relating to the enterprises; and

(2) for necessary administrative and nonadministrative expenses of the Office to carry out the purposes of this Act.

SEC. 106. ANNUAL REPORTS.

The Director shall submit to the Congress, not later than April 15 of each year, a written report, which shall include—

(1) a description of the actions taken, and being undertaken, by the Director to carry out this Act;

(2) a description of the financial safety and soundness of each enterprise, including the results and conclusions of the annual examinations of the enterprises conducted under section 211(a)(1); and

(3) any recommendations for legislation to enhance the financial safety and soundness of the enterprises.

SEC. 107. REGULATIONS AND ORDERS.

Subject to the approval of the Secretary (as provided in section 103(b)), the Director shall issue any such regulations and orders necessary to carry out the duties of the Director and to carry out this Act. The regulations under this section shall be issued after notice and opportunity for public comment pursuant to the provisions of section 553 of title 5, United States Code (notwithstanding subsections (b)(B) and (d)(3) of such section).

Subtitle B—Amendments to Other Acts

SEC. 121. AMENDMENTS TO FEDERAL NATIONAL MORTGAGE ASSOCIATION CHARTER ACT.

(a) CAPITALIZATION.—Section 303 of the Federal National Mortgage Association Charter Act (12 U.S.C. 1718) is amended—

(1) in subsection (a), by inserting after the period at the end the following new sentence: "The corporation may issue shares of common stock to mortgage sellers and borrowers in return for appropriate payments into capital or capital and surplus.";

(2) by striking subsection (b) and inserting the following new subsection:

"(b)(1) The corporation may impose charges or fees, which may be regarded as elements of pricing, with the

objective that all costs and expenses of the operations of the corporation should be within its income derived from such operations and that such operations should be fully self-supporting.

"(2) All earnings from the operations of the corporation shall annually be transferred to the general surplus account of the corporation. At any time, funds of the general surplus account may, in the discretion of the board of directors, be transferred to reserves.";

(3) by striking subsection (c) and inserting the following new subsection:

"(c)(1) Except as provided in paragraph (2), the corporation may pay to holders of its common stock such dividends as may be declared by the board of directors. All dividends shall be charged against the general surplus account of the corporation.

"(2) The corporation may not make any payment of dividends that would decrease the regulatory capital of the corporation (as such term is defined in section 3 of the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991) to an amount less than the risk-based capital level for the corporation established under section 201 of such Act or would result in the corporation not equaling or exceeding the minimum capital level for the corporation established under section

202 of such Act, without prior written approval of the payment by the Director of the Office of Secondary Market Examination and Oversight of the Department of Housing and Urban Development.

"(3) The Director of the Office of Secondary Market Examination and Oversight may require the corporation to submit a report to the Director before the declaration and payment of any dividend by the corporation. The report shall be made in such form and under such circumstances and shall contain such information as the Director shall require."; and

(4) in subsection (f)—

(A) by striking "to make payments" and all that follows through "such capital contributions,"; and

(B) by striking "additional shares of such stock," and inserting "shares of common stock of the corporation".

(b) OBLIGATIONS.—

(1) IN GENERAL.—Section 304 of the Federal National Mortgage Association Charter Act (12 U.S.C. 1719) is amended—

(A) in the first sentence of subsection (b), by striking the semicolon and all that follows

through "Secretary of Housing and Urban Development"; and

(B) in subsection (e), by striking the fourth sentence.

(2) EFFECTIVE DATE.—The amendments made by paragraph (1) shall take effect upon the expiration of the 2-year period beginning on the date of the enactment of this Act.

(c) ASSESSMENTS FOR OFFICE OF SECONDARY MARKET EXAMINATION AND OVERSIGHT.—The first sentence of section 304(f) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1719(f)) is amended by inserting after "section 309(g)" the following: "of this Act and section 105(a) of the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991".

(d) BOARD OF DIRECTORS.—

(1) IN GENERAL.—Effective on the date of the enactment of this Act, the second sentence of section 308(b) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1723(b)) is amended—

(A) by striking "and" after the second comma; and

(B) by inserting before the period at the end the following: ", and at least one person

who represents consumer interests or the interests of residents of low-income housing".

(2) IMPLEMENTATION.—The amendments made by paragraph (1) shall apply to the first annual appointment by the President of members to the board of directors of the Federal National Mortgage Association that occurs after the date of the enactment of this Act.

(e) COMPENSATION.—Section 309(d) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1723a(d)) is amended—

(1) in the first sentence of paragraph (2)—

(A) by inserting ", subject to paragraph (3)," before "to fix"; and

(B) by striking "as it may determine" and inserting the following: "as the board of directors determines reasonable and comparable with employment positions in other similar businesses involving similar duties and responsibilities"; and

(2) by adding at the end the following new paragraph:

"(3)(A) The compensation for any executive officer of the corporation who, after the date of the enactment of the Government-Sponsored Housing Enterprises Finan-

cial Safety and Soundness Act of 1991, accepts employment, accepts a new position, or renews any contract for employment as an executive officer of the corporation, shall not exceed the sum of (i) the level of compensation for an executive officer of the Federal Home Loan Mortgage Corporation with comparable duties and responsibilities under the compensation practices for the Federal Home Loan Mortgage Corporation in effect on July 1, 1991, and (ii) the aggregate amount of any adjustments under subparagraph (B).

"(B) The annual rate of pay for each executive officer position of the corporation may be adjusted pursuant to each adjustment in the rates of pay under the General Schedule under title 5, United States Code, that takes effect under section 5303 of such title on or after July 1, 1991. Each such adjustment shall be an amount not exceeding the amount equal to the percentage of such annual rate of pay which corresponds to the overall average percentage of the adjustment in the rates of pay under the General Schedule.

"(C) The Secretary of Housing and Urban Development shall review the compensation practices of the corporation to ensure compliance with the requirements of this paragraph. The Secretary shall review the duties and responsibilities of executive officers of the corporation and

may determine comparability under subparagraph (A) of such executive positions with executive positions of the Federal Home Loan Mortgage Corporation.

"(D) For purposes of this paragraph:

"(i) The term 'compensation' means any payment of money or the provision of any other thing of current or potential value in connection with employment.

"(ii) The term 'executive officer' means—

"(I) the chief executive officer of the corporation;

"(II) the chief financial officer of the corporation; and

"(III) any other individual who participates, or has authority to participate, in major policymaking functions of the corporation (other than in the capacity of a director), whether or not the individual has an official title, has a title designating the individual as an assistant, or is serving with compensation.".

(f) GENERAL REGULATORY POWERS.—Section 309(h) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1723a(h)) is amended to read as follows:

"(h)(1) Except for the authority of the Director of the Office of Secondary Market Examination and Oversight pursuant to section 103(a) of the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991, the Secretary of Housing and Urban Development shall have general regulatory authority over the Federal National Mortgage Association and shall make such rules and regulations as shall be necessary and proper to ensure that the purposes of this title are accomplished.

"(2)(A) The Secretary shall require that a reasonable portion of the corporation's mortgage purchases be related to the national goal of providing adequate housing for low- and moderate-income families, but with reasonable economic return to the corporation.

"(B) For purposes of this paragraph, the term 'low-income family' means a family or individual whose income does not exceed 80 percent of the median income for the area, as determined by the Secretary with adjustments for smaller and larger families, and the term 'moderate-income family' means a family or individual who is not a low-income family and whose income does not exceed 100 percent of the median income for the area, as determined by the Secretary with adjustments for smaller and larger families; except that the Secretary may establish income

ceilings for low- and moderate-income families higher and lower than 80 and 100 percent of the median for the area, respectively, if the Secretary determines that such variations are necessary because of prevailing levels of construction or rental costs or unusually high or low family incomes.

"(3) The corporation may not carry out any new program (as such term is defined in section 3 of the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991) without the prior written approval of the new program by the Secretary pursuant to a determination by the Secretary that the program conforms with the requirements and purposes of this title.

"(4) The Secretary may require the corporation to make reports on its activities as the Secretary deems advisable. The Secretary shall, not later than June 30 of each year, report to the Congress on the activities of the corporation under this title.".

(g) REQUESTS FOR APPROVAL.—The first sentence of section 309(i) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1723a(i)) is amended by striking ", after the date of the enactment of the Secondary Mortgage Market Enhancement Act of 1984,".

(h) GAO AUDITS.—The first sentence of section 309(j) of the Federal National Mortgage Association

Charter Act (12 U.S.C. 1723a(j)) is amended by striking "The mortgage transactions of the corporation may" and inserting "The financial transactions of the corporation shall".

(i) REPORTS TO DIRECTOR.—Section 309 of the Federal National Mortgage Association Charter Act (12 U.S.C. 1723a) is amended by adding at the end the following new subsection:

"(k)(1) The corporation shall submit to the Director of the Office of Secondary Market Examination and Oversight of the Department of Housing and Urban Development quarterly reports of the financial condition of the corporation which shall be in such form, contain such information, and be submitted on such dates as the Director of the Office of Secondary Market Examination and Oversight shall require.

"(2) Each report of condition shall contain a declaration by the president, vice president, treasurer, or any other officer designated by the board of directors of the corporation to make such declaration, that the report is true and correct to the best of such officer's knowledge and belief. The correctness of the report of condition shall be attested by the signatures of at least 3 of the members of the board of directors other than the officer making such declaration and shall include a declaration that each

such member has examined the report and that the report is true and correct to the best of each such officer's knowledge and belief.

"(3) The Director of the Office of Secondary Market Examination and Oversight may require the corporation to submit additional reports of financial condition, which shall be in such form, contain such information, and be submitted on such dates as the Director may require. The Director may also require the corporation to submit special reports whenever, in the judgment of the Director, such reports are necessary to carry out the purposes of the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991.".

(j) STOCK ISSUANCES.—The second sentence of section 311 of the Federal National Mortgage Association Charter Act (12 U.S.C. 1723c) is amended by striking "and all issuances of stock, and debt obligations convertible into stock, by the corporation".

(k) AFFORDABLE HOUSING PROGRAM.—The Federal National Mortgage Association Charter Act (12 U.S.C. 1716 et seq.) is amended by inserting after section 312 the following new section:

"AFFORDABLE HOUSING PROGRAM—FEDERAL NATIONAL MORTGAGE ASSOCIATION

"SEC. 313. (a) IN GENERAL.—The corporation shall carry out an affordable housing program under this sec-

tion to assist in acquisition, construction, and rehabilitation of rental housing (including limited equity cooperatives). Contributions by the corporation required under the affordable housing program shall be in addition to any requirements relating to low- and moderate-income housing under section 309(h).

"(b) CONTRIBUTIONS TO PROGRAM.—

"(1) PERCENTAGE OF EARNINGS.—In each year, the corporation shall reserve from the general surplus account of the corporation an amount equal to 20 percent of any dividends paid by the corporation during the preceding calendar year. Amounts reserved under this paragraph shall be used under the affordable housing program under this section.

"(2) PROHIBITION ON INCREASE OF FEES.— The corporation may not increase any fees or charges for services of the corporation as a result of the requirement under paragraph (1). The Secretary of Housing and Urban Development shall review the fees and charges imposed by the corporation, as the Secretary determines necessary, to ensure compliance with the requirements of this paragraph. If the Secretary determines that the corporation has increased fees or charges in violation of the first sentence of this paragraph, the Secretary may revise

such fees and charges as the Secretary considers appropriate.

"(c) EXEMPTION FOR INADEQUATE CAPITAL.—

"(1) IN GENERAL.—If at any time the Director of the Office of Secondary Market Examination and Oversight of the Department of Housing and Urban Development classifies the corporation as within enforcement level II, III, or IV (as established under section 204 of the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991), for the period during which the corporation is so classified, the corporation shall not be required to reserve amounts under subsection (b)(1) for use under the affordable housing program under this section.

"(2) TERMINATION OF EXEMPTION.—Upon reclassification of the corporation within enforcement level I (as established under section 204 of such Act), the Director of the Office of Secondary Market Examination and Oversight shall determine the percentage of dividends to be reserved by the corporation pursuant to subsection (b)(1) for use under the affordable housing program for the remainder of the calendar year during which such reclassification occurs. The percentage shall be reduced on a pro rata

basis to take into account the portion of the year during which the corporation was classified as within enforcement level II, III, or IV.

"(d) PROGRAM REQUIREMENTS.—The board of directors of the corporation shall establish requirements to implement the affordable housing program under this section, which shall—

"(1) specify priorities for using amounts reserved for use under the affordable housing program;

"(2) ensure that such amounts are used only for specific housing projects selected for assistance under the program by the board of directors;

"(3) provide that housing assisted with such amounts shall be rental housing for which, during the useful life of the housing—

"(A) not less than 20 percent of the units of the housing are occupied, or available for occupancy, only by families or individuals whose income does not exceed 50 percent of the median income for the area, as determined by the Secretary of Housing and Urban Development with adjustments for smaller and larger families; or

"(B) not less than 40 percent of the units of the housing are occupied, or available for occupancy, only by families or individuals whose income does not exceed 60 percent of the median income for the area, as determined by the Secretary with adjustments for smaller and larger families;

"(4) require the person acquiring, constructing, or rehabilitating a low-income housing project assisted under the program to certify that the housing will comply with paragraph (3) and any other requirements pursuant to this section;

"(5) coordinate activities under this section with other Federal and federally-subsidized affordable housing activities to the maximum extent possible; and

"(6) provide for national geographic diversity among housing projects assisted under this section.

"(e) MONITORING.—The Secretary of Housing and Urban Development shall monitor housing projects assisted under the affordable housing program under this section to ensure continued compliance with paragraph (3) and any other requirements pursuant to this section.

"(f) REPORT.—The corporation shall submit to the Secretary of Housing and Urban Development, not less

than annually, a report describing the activities of the corporation in carrying out the affordable housing program under this section.".

(l) TECHNICAL AMENDMENTS.—

(1) Section 302(c) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1717(c)) is amended—

(A) in paragraph (2)—

(i) in the first sentence following subparagraph (F), by striking "him" and inserting "the trustor"; and

(ii) in the last sentence, by striking "his" each place it appears and inserting "the trustor's"; and

(B) in paragraph (3), by striking "he" each place it appears and inserting "the trustor".

(2) Section 304(c) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1719(c)) is amended—

(A) by striking "his" each place it appears and inserting "the Secretary's"; and

(B) in the fourth sentence—

(i) by striking "he" and inserting "the Secretary"; and

(ii) by striking "him" and inserting "the Secretary".

(3) Section 309 of the Federal National Mortgage Association Charter Act (12 U.S.C. 1723a) is amended—

(A) in subsection (d)(2)—

(i) in the third sentence, by striking "his employment" each place it appears and inserting "the employment of such officer or employee"; and

(ii) in the last sentence, by striking "his basic pay" and inserting "the basic pay of such person"; and

(B) in subsection (e), by striking "he or it" and inserting "the individual, association, partnership, or corporation".

(m) EFFECTIVE DATE.—Except as provided in subsections (b)(2) and (d)(1), the amendments made by this section shall take effect on January 1, 1992.

SEC. 122. AMENDMENTS TO FEDERAL HOME LOAN MORTGAGE CORPORATION ACT.

(a) DEFINITIONS.—Section 302 of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1451) is amended by adding at the end the following new subsections:

"(m) The term 'low-income family' means a family or individual whose income does not exceed 80 percent of the median income for the area, as determined by the Secretary with adjustments for smaller and larger families, except that the Secretary may establish income ceilings higher and lower than 80 percent of the median for the area if the Secretary determines that such variations are necessary because of prevailing levels of construction or rental costs or unusually high or low family incomes.

"(n) The term 'moderate-income family' means a family or individual who is not a low-income family and whose income does not exceed 100 percent of the median income for the area, as determined by the Secretary with adjustments for smaller and larger families, except that the Secretary may establish income ceilings higher and lower than 100 percent of the median for the area if the Secretary determines that such variations are necessary because of prevailing levels of construction or rental costs or unusually high or low family incomes.".

(b) BOARD OF DIRECTORS.—

(1) IN GENERAL.—Effective on the date of the enactment of this Act, the second sentence of section 303(a)(2)(A) of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1452(a)(2)(A)) is amended—

(A) by striking "and" after the second comma; and

(B) by inserting before the period at the end the following: ", and at least one person who represents consumer interests or the interests of residents of low-income housing".

(2) IMPLEMENTATION.—The amendments made by paragraph (1) shall apply to the first annual appointment by the President of members to the Board of Directors of the Federal Home Loan Mortgage Corporation that occurs after the date of the enactment of this Act.

(c) GENERAL REGULATORY POWERS.—Section 303(b) of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1452(b)) is amended—

(1) in paragraph (1), by striking "The" and inserting the following: "Except for the authority of the Director of the Office of Secondary Market Examination and Oversight of the Department of Housing and Urban Development pursuant to section 103(a) of the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991, the";

(2) in paragraph (2), by striking "may require" and inserting "shall require";

(3) by striking paragraph (3) and inserting the following new paragraph:

"(3)(A) Except as provided in subparagraph (B), the Corporation may pay to holders of its common stock such dividends as may be declared by the Board of Directors.

"(B) The Corporation may not make any payment of dividends that would decrease the regulatory capital of the Corporation (as such term is defined in section 3 of the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991) to an amount less than the risk-based capital level for the Corporation established under section 201 of such Act or would result in the Corporation not equaling or exceeding the minimum capital level for the Corporation established under section 202 of such Act, without prior written approval of the payment by the Director of the Office of Secondary Market Examination and Oversight of the Department of Housing and Urban Development.

"(C) The Director of the Office of Secondary Market Examination and Oversight may require the Corporation to submit a report to the Director before the declaration and payment of any dividend by the Corporation. The report shall be made in such form and under such circumstances and shall contain such information as the Director shall require.";

(4) in paragraph (4), by striking "may examine and audit the books and financial transactions of the Corporation and"; and

(5) by striking paragraph (6) and inserting the following new paragraph:

"(6) The Corporation may not carry out any new program (as such term is defined in section 2 of the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991) without the prior written approval of the new program by the Secretary pursuant to a determination by the Secretary that the program conforms with the requirements and purposes of this title.".

(d) RATIO OF CAPITAL AND OBLIGATIONS.—Effective upon the expiration of the 3-year period beginning on the date of the enactment of this Act, section 303(b) of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1452(b)) is amended by striking paragraph (5).

(e) COMPENSATION.—Section 303 of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1452) is amended—

(1) in clause (9) of the first sentence of subsection (c)—

(A) by inserting "(subject to subsection (h))" before "fix"; and

(B) by inserting after "agents" the following: "as the Board of Directors determines reasonable and comparable with employment positions in other similar businesses involving similar duties and responsibilities"; and

(2) by adding at the end the following new subsection:

"(h)(1) Notwithstanding clause (9) of the first sentence of subsection (c), the compensation for any executive officer of the Corporation who, after the date of the enactment of the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991, accepts employment, accepts a new position, or renews any contract for employment as an executive officer of the Corporation, shall not exceed the sum of (A) the level of compensation for such executive position (or a position having comparable duties and responsibilities) under the compensation practices for the Corporation in effect on July 1, 1991, and (B) the aggregate amount of any adjustments under paragraph (2).

"(2) The annual rate of pay for each executive officer position of the Corporation may be adjusted pursuant to each adjustment in the rates of pay under the General Schedule under title 5, United States Code, that takes effect under section 5303 of such title on or after July 1,

1991. Each such adjustment shall be an amount not exceeding the amount equal to the percentage of such annual rate of pay which corresponds to the overall average percentage of the adjustment in the rates of pay under the General Schedule.

"(3) The Secretary of Housing and Urban Development shall review the compensation practices of the Corporation to ensure compliance with the requirements of this subsection. The Secretary shall review the duties and responsibilities of executive officers of the Corporation and may determine the comparability of such executive positions for purposes of paragraph (1).

"(4) For purposes of this subsection:

"(A) The term 'compensation' means any payment of money or the provision of any other thing of current or potential value in connection with employment.

"(B) The term 'executive officer' means—

"(i) the chief executive officer of the Corporation;

"(ii) the chief financial officer of the Corporation; and

"(iii) any other individual who participates, or has authority to participate, in major policymaking functions of the Corporation (other

than in the capacity of a director), whether or not the individual has an official title, has a title designating the individual as an assistant, or is serving with compensation.".

(f) CAPITAL STOCK.—Section 304 of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1453) is amended—

(1) in subsection (a)(1), by striking "The common stock" and all that follows and inserting the following: "The common stock of the Corporation shall consist of voting common stock, which shall be issued to such holders in the manner and amount, and subject to any limitations on concentration of ownership, as may be established by the Corporation.";

(2) in subsection (a)(2)—

(A) in the first sentence, by striking "nonvoting common stock and the"; and

(B) by striking the last sentence; and

(3) by striking subsections (b), (c), and (d).

(g) ASSESSMENTS FOR OFFICE OF SECONDARY MARKET EXAMINATION AND OVERSIGHT.—The first sentence of section 306(i) of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1455(i)) is amended by striking "section 303(c) or 306(c)" and inserting the following:

"sections 303(c) and 306(c) of this Act and section 105(a) of the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991".

(h) REPORTS TO DIRECTOR.—Section 307 of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1456) is amended by adding at the end the following new subsection:

"(c)(1) The Corporation shall submit to the Director of the Office of Secondary Market Examination and Oversight of the Department of Housing and Urban Development quarterly reports of the financial condition of the Corporation which shall be in such form, contain such information, and be submitted on such dates as the Director of the Office of Secondary Market Examination and Oversight shall require.

"(2) Each report of condition shall contain a declaration by the president, vice president, treasurer, or any other officer designated by the Board of Directors of the Corporation to make such declaration, that the report is true and correct to the best of such officer's knowledge and belief. The correctness of the report of condition shall be attested by the signatures of at least 3 of the members of the Board of Directors other than the officer making such declaration and shall include a declaration that each such member has examined the report and that the report

is true and correct to the best of each such officer's knowledge and belief.

"(3) The Director of the Office of Secondary Market Examination and Oversight may require the Corporation to submit additional reports of financial condition, which shall be in such form, contain such information, and be submitted on such dates as the Director shall require. The Director may also require the Corporation to submit special reports whenever, in the judgment of the Director, such reports are necessary to carry out the purposes of the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991.".

(i) AFFORDABLE HOUSING PROGRAM.—The Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1451 et seq.) is amended by adding at the end the following new section:

"AFFORDABLE HOUSING PROGRAM

"SEC. 311. (a) IN GENERAL.—The Corporation shall carry out an affordable housing program under this section to assist in acquisition, construction, and rehabilitation of rental housing (including limited equity cooperatives). Contributions by the Corporation required under the affordable housing program shall be in addition to any requirements relating to low- and moderate-income housing under section 303(b)(2).

"(b) CONTRIBUTIONS TO PROGRAM.—

"(1) Percentage of earnings.—In each year, the Corporation shall reserve from general surplus of the Corporation an amount equal to 20 percent of any dividends paid by the Corporation during the preceding calendar year. Amounts reserved under this paragraph shall be used under the affordable housing program under this section.

"(2) Prohibition on increase of fees.—The Corporation may not increase any fees or charges for services of the Corporation as a result of the requirement under paragraph (1). The Secretary of Housing and Urban Development shall review the fees and charges imposed by the Corporation, as the Secretary determines necessary, to ensure compliance with the requirements of this paragraph. If the Secretary determines that the Corporation has increased fees or charges in violation of the first sentence of this paragraph, the Secretary may revise such fees and charges as the Secretary considers appropriate.

"(c) Exemption for Inadequate Capital.—

"(1) In general.—If at any time the Director of the Office of Secondary Market Examination and Oversight of the Department of Housing and Urban Development classifies the Corporation as within en-

forcement level II, III, or IV (as established under section 204 of the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991), for the period during which the Corporation is so classified, the Corporation shall not be required to reserve amounts under subsection (b)(1) for use under the affordable housing program under this section.

"(2) TERMINATION OF EXEMPTION.—Upon reclassification of the Corporation within enforcement level I (as established under section 204 of such Act), the Director of the Office of Secondary Market Examination and Oversight shall determine the percentage of dividends to be reserved by the Corporation pursuant to subsection (b)(1) for use under the affordable housing program for the remainder of the calendar year during which such reclassification occurs. The percentage shall be reduced on a pro rata basis to take into account the portion of the year during which the Corporation was classified as within enforcement level II, III, or IV.

"(d) PROGRAM REQUIREMENTS.—The Board of Directors of the Corporation shall establish requirements to implement the affordable housing program under this section, which shall—

"(1) specify priorities for using amounts reserved for use under the affordable housing program;

"(2) ensure that such amounts are used only for specific housing projects selected for assistance under the program by the Board of Directors;

"(3) provide that housing assisted with such amounts shall be rental housing for which, during the useful life of the housing—

"(A) not less than 20 percent of the units of the housing are occupied, or available for occupancy, only by families or individuals whose income does not exceed 50 percent of the median income for the area, as determined by the Secretary of Housing and Urban Development with adjustments for smaller and larger families; or

"(B) not less than 40 percent of the units of the housing are occupied, or available for occupancy, only by families or individuals whose income does not exceed 60 percent of the median income for the area, as determined by the Secretary with adjustments for smaller and larger families;

"(4) require the person acquiring, constructing, or rehabilitating a low-income housing project assisted under the program to certify that the housing will comply with paragraph (3) and any other requirements pursuant to this section;

"(5) coordinate activities under this section with other Federal and federally-subsidized affordable housing activities to the maximum extent possible; and

"(6) provide for national geographic diversity among housing projects assisted under this section.

"(e) MONITORING.—The Secretary of Housing and Urban Development shall monitor housing projects assisted under the affordable housing program under this section to ensure continued compliance with paragraph (3) and any other requirements pursuant to this section.

"(f) REPORT.—The Corporation shall submit to the Secretary of Housing and Urban Development, not less than annually, a report describing the activities of the Corporation in carrying out the affordable housing program under this section.".

(j) EFFECTIVE DATE.—Except as provided in subsections (b)(1) and (d), the amendments made by this section shall take effect on January 1, 1992.

SEC. 123. AMENDMENTS TO TITLE 5, UNITED STATES CODE.

(a) DIRECTOR AT LEVEL II OF EXECUTIVE SCHEDULE.—Section 5313 of title 5, United States Code, is amended by inserting at the end the following new item:

"Director of the Office of Secondary Market Examination and Oversight, Department of Housing and Urban Development.".

(b) DEPUTY DIRECTOR AT LEVEL III OF EXECUTIVE SCHEDULE.—Section 5314 of title 5, United States Code, is amended by inserting at the end the following new item:

"Deputy Director of the Office of Secondary Market Examination and Oversight, Department of Housing and Urban Development.".

Subtitle C—Implementation

SEC. 131. IMPLEMENTATION.

(a) IN GENERAL.—The Secretary of Housing and Urban Development and the Director of the Office of Secondary Market Examination and Oversight of the Department of Housing and Urban Development, as appropriate, shall issue final regulations providing for the implementation of the provisions of this title and the amendments made by this title not later than the expiration of the 18-month period beginning on the date of the enactment of this Act. Such regulations shall clearly delineate the responsibilities and authority of the Secretary and the Director pursuant to the provision of and amendments made

by this title. Any regulations issued by the Director pursuant to this section shall be issued under the authority provided in section 107.

(b) NOTICE AND COMMENT.—The regulations under this section shall be issued after notice and opportunity for public comment pursuant to the provisions of section 553 of title 5, United States Code (notwithstanding subsections (b)(B) and (d)(3) of such section).

TITLE II—REQUIRED CAPITAL LEVELS FOR FNMA AND FHLMC AND SPECIAL ENFORCEMENT POWERS

SEC. 201. RISK-BASED CAPITAL LEVELS.

(a) ESTABLISHMENT.—Not later than the expiration of the 1-year period beginning on the date of the enactment of this Act, the Director shall, by regulation, establish risk-based capital levels under this section for each enterprise. The risk-based capital level for each enterprise shall be an amount of regulatory capital that is equal to the sum of the following amounts:

(1) CREDIT RISK.—The amount of regulatory capital that the Director determines is sufficient for the enterprise to maintain positive capital for an 8-year period during which losses occur on a national scale, for all mortgages owned or guaranteed by the

enterprise, at the rate of default and severity equal to the rate and severity occurring in the standard region during the worst mortgage loss experience.

(2) INTEREST RATE RISK.—The amount of regulatory capital that the Director determines is sufficient for the enterprise to maintain positive capital for an 8-year period during which either of the following circumstances occur:

(A) Interest rates on Treasury obligations having a maturity of 10 years increase over the first 12 months of such 8-year period by the lesser of (i) 50 percent (with respect to the average interest rates on such obligations during the 12-month period preceding the 8-year period), or (ii) 500 basis points, and remain at such level for the remainder of the period.

(B) Interest rates on such Treasury obligations decrease over the first 12 months of such 8-year period by the lesser of (i) 50 percent (with respect to the average interest rates on such obligations during the 12-month period preceding the 8-year period), or (ii) 500 basis points, and remain at such level for the remainder of the period.

(3) MANAGEMENT AND OPERATIONS RISK.—To provide for management and operations risk, 20 percent of the amount of regulatory capital determined for the enterprise under paragraphs (1) and (2), except that the Director may increase or decrease such percentage for each enterprise as the Director determines appropriate to reflect actual management and operations risk.

(4) NEW PROGRAM RISK.—If the Director determines that the risk to capital of the enterprise posed by any new program of the enterprise (approved by the Secretary under section 309(h)(3) of the Federal National Mortgage Association Charter Act or section 303(b)(6) of the Federal Home Loan Mortgage Corporation Act, as appropriate) is not adequately provided for under paragraphs (1), (2), and (3), the amount of regulatory capital that the Director establishes as appropriate to provide for such additional risk posed by the new program.

(b) CONSIDERATIONS.—In establishing risk-based capital levels under this section and compliance with such levels under this title, the Director shall take into account appropriate distinctions based on various types of mortgage products and seasoning of mortgages.

(c) REGIONS.—For purposes of this section, the Director shall, by regulation, establish regions. Each region shall—

(1) consist of a State or 2 or more contiguous States; and

(2) have a population of not less than 5 percent of the population of the United States, based on the most recent decennial census.

(d) DEFINITIONS.—For purposes of this section:

(1) SEASONING.—The term "seasoning" means the change over time in the ratio of the unpaid principal balance of a mortgage to the value of the property by which such mortgage loan is secured, determined on an annual basis by region, in accordance with the Constant Quality Home Price Index published by the Secretary of Commerce (or any successor index of similar quality, authority, and public availability that is regularly used by the Federal Government).

(2) STANDARD REGION.—The term "standard region" means the region having, for any period of not less than 3 years for which reliable data exist, the highest average default rate and severity of losses for conventional mortgages (A) having a fixed rate of interest, (B) purchased by the enterprises,

(C) having terms of 30 years, and (D) secured by residences located in the region.

(3) TYPE OF MORTGAGE PRODUCT.—The term "type of mortgage product" means a classification of one or more mortgage products, as established by the Director, which have similar characteristics from each set of characteristics under the following subparagraphs:

(A) The property securing the mortgage is—

(i) a single-family residential property; or

(ii) a multifamily residential property.

(B) The interest rate on the mortgage is—

(i) fixed; or

(ii) adjustable.

(C) The priority of the lien securing the mortgage is—

(i) first; or

(ii) second or other.

(D) The term of the mortgage is—

(i) 1 to 15 years;

(ii) 16 to 30 years; or

(iii) more than 30 years.

(E) The owner of the property is—

(i) an owner-occupant; or

(ii) an investor.

(F) The unpaid principal balance of the mortgage—

(i) will amortize completely over the term of the mortgage and will not increase significantly at any time during the term of the mortgage;

(ii) will not amortize completely over the term of the mortgage and will not increase significantly at any time during the term of the mortgage; or

(iii) may increase significantly at some time during the term of the mortgage.

(4) WORST MORTGAGE LOSS EXPERIENCE.—The term "worst mortgage loss experience" means, as determined by the Director, the 3-year period during which the standard region had the highest average default rate and severity of losses described in paragraph (2).

SEC. 202. MINIMUM CAPITAL LEVELS.

(a) ESTABLISHMENT.—For purposes of this title, the minimum capital level for each enterprise shall be—

(1) an amount of marked-to-market equity of the enterprise equal to—

(A) 2.0 percent of the on-balance sheet assets of the enterprise; and

(B) 1.0 percent of the unpaid principal balance of off-balance sheet obligations of the enterprise with respect to residential mortgages; and

(2) an amount of core capital equal to—

(A) 1.5 percent of the on-balance sheet assets of the enterprise; and

(B) 0.5 percent of the unpaid principal balance of off-balance sheet obligations of the enterprise with respect to residential mortgages.

(b) MARKED-TO-MARKET EQUITY.—For purposes of this title, the term "marked-to-market equity of the enterprise" means the difference between—

(1) the current market value of on- and off-balance sheet assets of the enterprise; and

(2) the current market value of on- and off-balance sheet obligations of the enterprise.

The Director shall provide, by regulation, for determinations of market value to be made in accordance with principles of marked-to-market accounting, including valu-

ation techniques, adopted or recommended from time to time by the Financial Accounting Standards Board.

(c) USE OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES.—For the purposes of this section, on-balance sheet assets and off-balance sheet obligations shall be determined according to generally accepted accounting principles as adopted or recommended from time to time by the Financial Accounting Standards Board.

SEC. 203. CRITICAL CAPITAL LEVELS.

(a) ESTABLISHMENT.—For purposes of this title, the critical capital level for each enterprise shall be—

(1) an amount of marked-to-market equity of the enterprise equal to 50 percent of the amount determined under section 202(a)(1); and

(2) an amount of core capital equal to 50 percent of the amount determined under section 202(a)(2).

SEC. 204. ENFORCEMENT LEVELS.

(a) IN GENERAL.—The Director shall classify the enterprises, for purposes of this title, according to the following enforcement levels:

(1) LEVEL I.—An enterprise shall be classified as within level I if the enterprise—

(A) maintains an amount of regulatory capital that is equal to or exceeds the risk-

based capital level established for the enterprise under section 201; and

(B) equals or exceeds the minimum capital level for the enterprise established under section 202.

(2) LEVEL II.—An enterprise shall be classified as within level II if—

(A) the enterprise—

(i) maintains an amount of regulatory capital that is less than the risk-based capital level established for the enterprise; and

(ii) equals or exceeds the minimum capital level for the enterprise; or

(B) the enterprise is otherwise classified within level II under subsection (b) of this section.

(3) LEVEL III.—An enterprise shall be classified as within level III if—

(A) the enterprise—

(i) does not equal or exceed the minimum capital level for the enterprise; and

(ii) equals or exceeds the critical capital level for the enterprise established under section 203; or

(B) the enterprise is otherwise classified within level III under subsection (b) of this section.

(4) LEVEL IV.—An enterprise shall be classified as within level IV if the enterprise—

(A) does not equal or exceed the critical capital level for the enterprise; or

(B) is otherwise classified within level IV under subsection (b) of this section.

(b) DISCRETIONARY CLASSIFICATION.—If at any time the Director determines in writing that an enterprise is taking any action not approved by the Director that could result in a rapid depletion of capital or that the value of the property secured by mortgages held or set aside by the enterprise has decreased significantly, the Director may classify the enterprise—

(1) as within level II or III, as the Director considers appropriate, if the enterprise is otherwise within level I;

(2) as within level III or IV, as the Director considers appropriate, if the enterprise is otherwise within level II; or

(3) as within level IV if the enterprise is otherwise within level III.

(c) QUARTERLY DETERMINATION.—The Director shall determine the classification of the enterprises for purposes of this title on not less than a quarterly basis (and as appropriate under subsection (b)). The first such determination shall be made for the quarter ending March 31, 1992.

SEC. 205. MANDATORY SUPERVISORY ACTIONS APPLICABLE TO ENTERPRISES WITHIN LEVEL II.

(a) NOTICE.—Upon determining that an enterprise is within level II, the Director shall provide written notice to the Congress and to the enterprise—

(1) that the enterprise is within level II;

(2) that the enterprise is subject to the provisions of this section; and

(3) stating the reasons for the classification of the enterprise within level II.

(b) CAPITAL RESTORATION PLAN.—An enterprise within level II shall, within the time period provided in section 209(b) and in consultation with the Director, submit to the Director a capital restoration plan that complies with section 209 and, after approval, carry out the plan.

(c) RESTRICTION ON DIVIDENDS.—An enterprise within level II may not make any payment of dividends that would result in the enterprise being reclassified as within level III or IV.

(d) RECLASSIFICATION FROM LEVEL II TO LEVEL III.—The Director shall immediately reclassify an enterprise within level II as within level III (and the enterprise shall be subject to the provisions of section 206), if—

(A) the enterprise does not submit the capital restoration plan required under subsection (b) within the applicable period; or

(B) the Director determines that the enterprise has failed to make, in good faith, all reasonable efforts necessary to comply with the capital plan and fulfill the schedule for the plan approved by the Director.

(e) EFFECTIVE DATE.—This section shall take effect upon the expiration of the 2-year period beginning on the date of the enactment of this Act.

SEC. 206. SUPERVISORY ACTIONS APPLICABLE TO ENTERPRISES WITHIN LEVEL III.

(a) MANDATORY SUPERVISORY ACTIONS.—

(1) CAPITAL RESTORATION PLAN.—An enterprise within level III shall, within the time period provided in section 209(b), submit to the Director a capital restoration plan that complies with section 209 and, after approval, carry out the plan.

(2) RESTRICTIONS ON DIVIDENDS.—

(A) PRIOR APPROVAL.—An enterprise within level III may not make any payment of dividends that would result in the enterprise being reclassified as within level IV. An enterprise within level III may make any other payment of dividends only if the Director approves the payment before the payment.

(B) STANDARD FOR APPROVAL.—The Director may approve a payment of dividends by an enterprise within level III only if the Director determines that the payment (i) will enhance the ability of the enterprise to meet the risk-based capital level and the minimum capital level for the enterprise promptly or (ii) is otherwise in the public interest.

(3) APPROVAL OF ACTIVITIES.—An enterprise within level III may undertake an activity subject to the approval of the Secretary under the Federal National Mortgage Association Charter Act or the Federal Home Loan Mortgage Corporation Act only with the additional approval of the Director.

(4) RECLASSIFICATION FROM LEVEL III TO LEVEL IV.—The Director shall immediately reclassify an enterprise within level III as within level IV

(and the enterprise shall be subjeet to the provisions of section 207), if—

(A) the enterprise does not submit the capital restoration plan required under paragraph (1) within the applicable period; or

(B) the Director determines that the enterprise has failed to make, in good faith, all reasonable efforts necessary to comply with the capital plan and fulfill the schedule for the plan approved by the Director.

(b) DISCRETIONARY SUPERVISORY ACTIONS.—In addition to any other actions taken by the Director (including actions under subsection (a)), the Director may, at any time, take any of the following actions with respect to an enterprise within level III:

(1) LIMITATION ON INCREASE IN OBLIGATIONS.—Limit any increase in, or order the reduction of, any obligations of the enterprise, including off-balance sheet obligations.

(2) LIMITATION ON GROWTH.—Limit or prohibit the growth of the assets of the enterprise or require contraction of the assets of the enterprise.

(3) PROHIBITION ON DIVIDENDS.—Prohibit the enterprise from making any payment of dividends.

(4) ISSUANCE OF NEW CAPITAL.—Require the enterprise to issue new capital in any form and in any amount sufficient to provide for the reclassification of the enterprise as within level II.

(5) RESTRICTION OF ACTIVITIES.—Require the enterprise to terminate, reduce, or modify any activity that the Director determines creates excessive risk to the enterprise.

(6) CONSERVATORSHIP.—Appoint a conservator for the enterprise pursuant to section 208.

(c) EFFECTIVE DATE.—This section shall take effect upon the expiration of the 1-year period beginning on the date of the enactment of this Act.

SEC. 207. MANDATORY APPOINTMENT OF CONSERVATOR FOR ENTERPRISES WITHIN LEVEL IV.

(a) NOTICE.—Upon determining that an enterprise is within level IV, the Director shall provide written notice to the Congress and to the enterprise—

(1) that the enterprise is within level IV;

(2) that a conservator shall be appointed for the enterprise pursuant to this section.

(b) APPOINTMENT.—If the Director determines that an enterprise is within level IV, the Director shall, not later than 30 days after providing notice under subsection (a), appoint a conservator for the enterprise. A conserva-

tor appointed pursuant to this section shall have the authority, in the discretion of the conservator, to take any actions under sections 205 and 206 not inconsistent with the authority of the conservator and to take any other actions authorized under section 208.

(c) APPROVAL OF ACTIVITIES.—The conservator of any enterprise within level IV may undertake an activity subject to the approval of the Secretary under the Federal National Mortgage Association Charter Act or the Federal Home Loan Mortgage Corporation Act only with the additional approval of the Director.

(d) EFFECTIVE DATE.—This section shall take effect on January 1, 1992.

SEC. 206. CONSERVATORSHIP.

(a) APPOINTMENT.—

(1) DISCRETIONARY AUTHORITY.—The Director may, after providing notice under paragraph (2), appoint a conservator for an enterprise upon a determination—

(A) that the enterprise is not likely to pay its obligations in the normal course of business;

(B) that—

(i) the enterprise has incurred or is likely to incur losses that will deplete all or substantially all of its core capital; and

(ii) there is no reasonable likelihood that the enterprise will replenish its core capital without Federal assistance;

(C) that the enterprise has concealed books, papers, records, or assets of the enterprise, or refused to submit books, papers, records, or information regarding the affairs of the enterprise for inspection to the Director upon request; or

(D) that the enterprise is classified within Level III.

(2) NOTICE.—Upon making a determination under paragraph (1) to appoint a conservator under this section for an enterprise, the Director shall provide written notice to the Congress and to the enterprise—

(A) that a conservator will be appointed for the enterprise under this section; and

(B) stating the reasons under paragraph (1) for the appointment of the conservator.

(b) JUDICIAL REVIEW.—

(1) IN GENERAL.—

(A) TIMING AND JURISDICTION.—An enterprise for which a conservator is appointed (pursuant to this section or section 207) may

bring an action in the United States district court for the judicial district in which the home office of such enterprise is located or in the United States District Court for the District of Columbia, for an order requiring the Director to terminate the appointment of the conservator. Such an action may be commenced only before the expiration of the 20-day period beginning upon the appointment of the conservator.

(B) STANDARD.—A decision of the Director to appoint a conservator may be set aside under this paragraph only if the court finds that the decision was arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with applicable laws.

(2) STAY.—

(A) IN GENERAL.—A conservator appointed pursuant to this section or section 207 may request that any judicial action or proceeding to which the conservator or the enterprise is or may become a party be stayed for a period not exceeding 45 days and commencing upon the appointment of the conservator. Upon petition, the court shall grant such stay as to all parties.

(B) DIRECTOR OR FEDERAL AGENCY AS CONSERVATOR.—In any case in which the conservator appointed for an enterprise is the Director, a Federal agency, or an officer or employee of the Federal Government, the conservator may make a request for a stay under subparagraph (A) only with the prior consent of the Attorney General and subject to the direction and control of the Attorney General.

(3) ACTIONS AND ORDERS.—

(A) LIMITATION ON REMEDIES.—Except as otherwise provided in this subsection, no court may take any action regarding the removal of a conservator or otherwise restrain or affect the exercise of powers or functions of a conservator.

(B) ENFORCEMENT OF ORDERS.—The Director, with the prior consent of the Attorney General and subject to the direction and control of the Attorney General, may apply to a court which shall have the jurisdiction to enforce an order of the Director relating to—

(i) the conservatorship and the enterprise in conservatorship; or

(ii) restraining or affecting the exercise of authority or functions of a conservator.

(c) APPOINTMENT BY CONSENT.—Notwithstanding subsection (a), the Director may appoint a conservator for an enterprise if the enterprise, by an affirmative vote of a majority of its board of directors or by an affirmative vote of a majority of its shareholders, consents to such appointment.

(d) EXCLUSIVE APPOINTMENT AUTHORITY.—The Director shall have exclusive authority to appoint a conservator for an enterprise.

(e) REPLACEMENT OF CONSERVATOR.—The Director may, without notice or hearing, replace a conservator with another conservator. Such replacement shall not affect the right of the enterprise under subsection (b) to obtain judicial review of the decision of the Director to appoint a conservator.

(f) EXAMINATIONS.—The Director may examine and supervise any enterprise in conservatorship during the period in which the enterprise continues to operate as a going concern.

(g) TERMINATION.—

(1) DISCRETIONARY.—At any time the Director determines that termination of a conservatorship

pursuant to an appointment under subsection (a) is in the public interest and may safely be accomplished, the Director may terminate the conservatorship and permit the enterprise to resume the transaction of its business subject to such terms, conditions, and limitations as the Director may prescribe.

(2) MANDATORY.—The Director shall terminate a conservatorship pursuant to section 207 upon a determination by the Director that the enterprise equals or exceeds the minimum capital level for the enterprise established under section 201. The Director may not impose any terms, conditions, or limitations on the transaction of business of an enterprise whose conservatorship is terminated under this paragraph.

(h) POWERS AND DUTIES.—

(1) DIRECTOR.—When acting as a conservator, the Director may exercise any authority of the Director under this Act, and (when not inconsistent therewith) shall have all other rights, authority, and privileges possessed by conservators under this section and any other applicable laws.

(2) GENERAL POWERS.—A conservator shall have all the powers of the shareholders, directors,

and officers of the enterprise under conservatorship and may operate the enterprise in the name of the enterprise, unless the Director provides otherwise.

(3) LIMITATIONS BY DIRECTOR.—A conservator shall be subject to any rules, regulations, and orders issued from time to time by the Director and, except as otherwise specifically provided in such rules, regulations, or orders or in subsection (i), shall have the same rights and privileges and be subject to the same duties, restrictions, penalties, conditions, and limitations applicable to directors, officers, or employees of the enterprise.

(4) PAYMENT OF CREDITORS.—The Director may require a conservator to set aside and make available for payment to creditors any amounts that the Director determines may safely be used for such purpose. All creditors who are similarly situated shall be treated in a similar manner.

(5) COMPENSATION OF CONSERVATOR AND EMPLOYEES.—A conservator (other than the Director) and professional emplo[illegible]ther than Federal employees) appointed t[illegible] or assist the conservator may be co[illegible] for activities cond[illegible] as conservator. [illegible] in amounts g[illegible]

employees of the Federal Government for similar services, except that the Director may provide for compensation at higher rates (but not in excess of rates prevailing in the private sector), if the Director determines that compensation at higher rates is necessary in order to recruit and retain competent personnel.

(6) EXPENSES.—All expenses of a conservatorship pursuant to this section (including compensation under paragraph (5)) shall be paid by the enterprise and shall be a secured by a lien on the enterprise, which shall have priority over any other lien.

(i) LIABILITY PROTECTIONS.—

(1) FEDERAL AGENCIES AND EMPLOYEES.—In any case in which the conservator is the Director, a Federal agency, or an officer or employee of the Federal Government, the provisions of chapters 161 and 171 of title 28, United States Code, shall apply with respect to the liability of the conservator for acts or omissions performed pursuant to and in the course of the duties and responsibilities of the conservatorship.

(2) OTHER CONSERVATORS.—In any case where the conservator is not a conservator described in

paragraph (1), the conservator shall not be liable for damages in tort or otherwise for acts or omissions performed pursuant to and in the course of the duties and responsibilities of the conservatorship, unless such acts or omissions constitute gross negligence, including any similar conduct or any form of intentional tortious conduct.

(3) INDEMNIFICATION.—The Director, with the approval of the Attorney General, may indemnify the conservator on such terms as the Director considers appropriate.

(j) AUTHORITY OF OFFICERS.—This section may not be construed to impair in any manner any authority of the President, the Secretary of the Treasury, the Director, or the Attorney General.

SEC. 209. CAPITAL RESTORATION PLANS.

(a) CONTENTS.—Each capital restoration plan submitted under this title shall set forth a feasible plan for the enterprise to promptly equal or exceed the minimum capital level for the enterprise and for promptly restoring the level of regulatory capital of the enterprise subject to the plan to not less than the risk-based capital level for the enterprise. Each capital restoration plan shall—

(1) specify the level of capital the enterprise will achieve and maintain;

(2) describe the actions that the enterprise will take to equal or exceed the minimum capital level for the enterprise and to restore the regulatory capital of the enterprise to not less than the risk-based capital level for the enterprise;

(3) establish a schedule for promptly completing the capital restoration plan;

(4) specify the types and levels of activities in which the enterprise will engage during the term of the capital restoration plan; and

(5) describe the actions that the enterprise will take to comply with any mandatory and discretionary requirements imposed under this title.

(b) DEADLINES FOR SUBMISSION.—The Director shall, by regulation, establish a deadline for submission of a capital restoration plan, which may not be more than 30 days after the enterprise is notified that a plan is required. The regulations shall provide that the Director may extend the deadline to the extent that the Director determines necessary. Any extension of the deadline shall be in writing and for a time certain.

(c) APPROVAL.—The Director shall review each capital restoration plan submitted under this section and, not later than 30 days after submission of the plan, approve or disapprove the plan. The Director may extend the peri-

od for approval or disapproval for any plan for a single additional 30-day period if the Director determines necessary. The Director shall notify any enterprise submitting a plan in writing of the approval or disapproval of the plan and of any extension of the period for approval or disapproval. The Director shall provide by regulation for resubmission and review of any plans disapproved.

SEC. 210. JUDICIAL REVIEW OF DIRECTOR ACTION.

(a) JURISDICTION.—

(1) FILING OF PETITION.—A person aggrieved by an action of the Director under this title (other than action under section 207) may obtain review of the action by filing, within 10 days after receiving notice of the Director's action, a written petition requesting that the action of the Director be modified, terminated, or set aside.

(2) PLACE FOR FILING.—A petition filed pursuant to this subsection shall be filed in the United States Court of Appeals for the District of Columbia Circuit or the United States Court of Appeals for the circuit in which the concerned enterprise maintains its principal office.

(3) DEFINITIONS.—For purposes of this subsection—

(A) the term "concerned enterprise" means the enterprise whose classification within a particular enforcement level under section 204 is the basis for the Director's action of which the person aggrieved complains; and

(B) the term "person aggrieved by an action of the Director" means, with respect to an enterprise within level I, II, or III, the enterprise or company that is the subject of a mandatory or discretionary supervisory action taken under this title.

(b) SCOPE OF REVIEW.—An action taken by the Director under this section may be modified, terminated, or set aside only if the court finds, on the record on which the Director acted, that the action of the Director was arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with applicable laws.

(c) WITHDRAWAL OF JURISDICTION.—Except as provided in this section, no court shall have jurisdiction to affect, by injunction or otherwise, the issuance or effectiveness of any action of the Director under this section or to review, modify, suspend, terminate, or set aside such action.

SEC. 211. EXAMINATIONS.

(a) TIMING.—

annually conduct an examination under of each enterprise to determine the condition of the enterprise for the purpose of ensuring its financial safety and soundness.

(2) OTHER EXAMINATIONS.—Whenever the Director determines that an examination is necessary to determine the condition of an enterprise for the purpose of ensuring its financial safety and soundness the Director may conduct an examination under this section.

(b) EXAMINERS.—Examinations under this section shall be conducted only by the Director and officers and employees of the Office of Secondary Market Examination and Oversight. The Director may not base any decision or action under this title primarily upon information provided by technical experts or other entities that are not officers or employees of the Office.

(c) TECHNICAL EXPERTS.—The Director may obtain the services of any technical experts the Director considers necessary and appropriate to provide temporary technical assistance relating to examinations to the Director and officers and employees of the Office of Secondary Market Examination and Oversight. The Director shall describe,

in the public record of each examination, the nature and extent of any such temporary technical assistance.

(d) OATHS, EVIDENCE, SUBPOENA POWERS.—In connection with examinations under this section, the Director may—

(1) administer oaths and affirmations;

(2) take and preserve testimony under oath; and

(3) issue subpoenas requiring the attendance and testimony of witnesses and the production of evidence.

The attendance of witnesses and the production of evidence may be required from any place within any State at any designated place where a hearing relating to an examination is conducted.

(e) SECOND EXAMINATION BY GAO.—Upon a determination by the Director that an examination of an enterprise under this subsection is necessary, the Comptroller General shall conduct an examination of the enterprise solely to provide an independent determination regarding the safety and soundness of the enterprise. The examination shall be conducted at a time and in a manner that results in minimal disruption to the normal business activities of the enterprise. The Comptroller General may obtain the services of technical experts in the same manner

as the Director may obtain such services under subsection (c), except that any entity that assists the Director in examining an enterprise may not concurrently assist the Comptroller General to examine the enterprise under this subsection.

SEC. 212. CIVIL MONEY PENALTIES FOR FAILURE TO REPORT.

(a) UNINTENTIONAL VIOLATIONS.—

(1) VIOLATIONS.—The Director may impose a civil money penalty, in accordance with the provisions of this section, on any enterprise that—

(A) maintains reasonable procedures designed to prevent errors and unintentionally submits to the Director (i) any false or misleading report under section 309(k) of the Federal National Mortgage Association Charter Act or section 307(c) of the Federal Home Loan Mortgage Corporation Act, or (ii) any false or misleading information; or

(B) submits any report referred to in subparagraph (A) minimally late.

(2) AMOUNT.—The amount of a penalty under this paragraph, as determined by the Director, may not exceed $500 per day for each day during which

such failure continues or such false or misleading information is not corrected.

(b) FAILURE TO SUBMIT REPORT.—The Director may impose a civil money penalty, in accordance with the provisions of this section, on any enterprise that fails to make any report required under section 309(k) of the Federal National Mortgage Association Charter Act or section 307(c) of the Federal Home Loan Mortgage Corporation Act within the period of time established by the Director for submission of the report (other than failure described in subsection (a)(1)(B)). The amount of the penalty, as determined by the Director, may not exceed $10,000 per day for each day during which such failure continues.

(c) INTENTIONAL VIOLATIONS.—The Director may impose a civil money penalty, in accordance with the provisions of this section, on any enterprise that submits to the Director any false or misleading report or information with actual knowledge of inaccuracy, deliberate ignorance of inaccuracy, or reckless disregard for accuracy. The amount of the penalty may not exceed $1,000,000 or 1 percent of total assets of the enterprise, whichever is less, per day for each day during which such failure continues or such false or misleading information is not corrected.

(d) PROCEDURES.—

(1) ESTABLISHMENT.—The Director shall establish standards and procedures governing the imposition of civil money penalties under subsections (a), (b), and (c). The standards and procedures—

(A) shall provide for the Director to make the determination to impose the penalty;

(B) shall provide for the imposition of a penalty only after the enterprise has been given notice of, and opportunity for, a hearing on the record; and

(C) may provide for review by the Director of any determination or order, or interlocutory ruling, arising from a hearing.

(2) FINAL ORDERS.—If the enterprise does not request a hearing within 15 days after receipt of a notice of opportunity for hearing, the imposition of a penalty shall constitute a final and unappealable determination. If the Director reviews the determination or order, the Director may affirm, modify, or reverse the determination or order. If the Director does not review the determination or order within 90 days after the issuance of the determination or order, the determination or order shall be final.

(3) FACTORS IN DETERMINING AMOUNT OF PENALTY.—In determining the amount of a penalty

under subsection (a), (b), or (c), the Director shall give consideration to such factors as the gravity of the violation, any history of prior violations (including violations occurring before the date under subsection (j)), the effect of the penalty on the safety and soundness of the enterprise, any injury to the public, any benefits received, and deterrence of future violations, and any other factors the Director may determine by regulation.

(4) REVIEWABILITY OF IMPOSITION OF PENALTY.—The determination or order of the Director imposing a penalty under subsection (a), (b), or (c) shall not be subject to review, except as provided in subsection (e).

(e) JUDICIAL REVIEW OF DETERMINATION.—

(1) IN GENERAL.—After exhausting all administrative remedies established by the Director under subsection (d)(1), an enterprise against which the Director has imposed a civil money penalty under subsection (a), (b), or (c) may obtain review of the penalty and such ancillary issues as may be addressed in the notice of the determination to impose a penalty under subsection (d)(1)(A) in the appropriate court of appeals of the United States, by filing in such court, within 20 days after the entry of

such order or determination, a written petition praying that the order or determination of the Director be modified or be set aside in whole or in part.

(2) OBJECTIONS NOT RAISED IN HEARING.—A court shall not consider any objection not raised in a hearing conducted pursuant to subsection (d)(1) unless a demonstration is made of extraordinary circumstances causing the failure to raise the objection. If any party demonstrates to the satisfaction of the court that additional evidence, not presented at such hearing, is material and that there were reasonable grounds for the failure to present such evidence at the hearing, the court shall remand the matter to the Director for consideration of the additional evidence.

(3) SCOPE OF REVIEW.—The review of the decisions, findings, and determinations of the Director shall be conducted pursuant to section 706 of title 5, United States Code.

(4) ORDER TO PAY PENALTY.—Notwithstanding any other provision of law, the court shall have the authority in any such review to order payment of the penalty imposed by the Director.

(f) ACTION TO COLLECT PENALTY.—If an enterprise fails to comply with a determination or order of the Direc-

tor imposing a civil money penalty under subsection (a), (b), or (c), after the determination or order is no longer subject to review as provided by subsections (d)(1) and (e), the Director may request the Attorney General of the United States to bring an action in an appropriate district court to obtain a monetary judgment against the enterprise and such other relief as may be available. The monetary judgment may, in the discretion of the court, include any attorneys fees and other expenses incurred by the United States in connection with the action. In an action under this subsection, the validity and appropriateness of the determination or order of the Director imposing the penalty shall not be subject to review.

(g) SETTLEMENT BY DIRECTOR.—The Director may compromise, modify, or remit any civil money penalty which may be, or has been, imposed under this section.

(h) AVAILABILITY OF OTHER REMEDIES.—Any civil money penalty under this section shall be in addition to any other available civil remedy or criminal penalty and may be imposed whether or not the Director imposes other administrative sanctions.

(i) DEPOSIT OF PENALTIES.—The Secretary shall deposit any civil money penalties collected under this section into the Secondary Market Examination and Oversight Fund established in section 105(b).

(j) APPLICABILITY.—This section shall apply only to violations under subsections (a), (b), and (c) occurring on or after January 1, 1992.

TITLE III—CEASE AND DESIST ORDERS AGAINST FNMA AND FHLMC

SEC. 301. CEASE-AND-DESIST PROCEEDINGS.

(a) GROUNDS FOR ISSUANCE.—The Director may issue and serve upon an enterprise a notice of charges under this section if, in the determination of the Director, the enterprise—

(1) is engaging or has engaged, or the Director has reasonable cause to believe that the enterprise is about to engage, in any activity that could result in a rapid depletion of the core capital of the enterprise; or

(2) is violating or has violated, or the Director has reasonable cause to believe that the enterprise is about to violate—

(A) any law, rule, or regulation;

(B) any condition imposed in writing by the Director in connection with the granting of any application or other request by the enterprise; or

(C) any written agreement entered into by the enterprise with the Director.

(b) PROCEDURE.—

(1) NOTICE OF CHARGES.—Each notice of charges shall contain a statement of the facts constituting the alleged violation or violations or the activity that could result in a rapid depletion of the capital of the enterprise, and shall fix a time and place at which a hearing will be held to determine whether an order to cease and desist from such violation or activity should issue against the enterprise.

(2) DATE OF HEARING.—A hearing pursuant to a notice under paragraph (1) shall be fixed for a date not earlier than 30 days nor later than 60 days after service of the notice unless an earlier or a later date is set by the Director at the request of the enterprise served.

(3) FAILURE TO APPEAR.—Unless the enterprise served appears at the hearing through a duly authorized representative, the enterprise shall be deemed to have consented to the issuance of the cease-and-desist order.

(4) ISSUANCE OF ORDER.—In the event of such consent, or if, upon the record made at any such hearing, the Director finds that any violation or ac-

tivity that could result in a rapid depletion of the capital of the enterprise specified in the notice of charges has been established, the Director may issue and serve upon the enterprise an order requiring the enterprise to cease and desist from any such violation or activity and to take affirmative action to correct the conditions resulting from any such violation or activity.

(c) AFFIRMATIVE ACTION TO CORRECT CONDITIONS RESULTING FROM VIOLATIONS OR ACTIVITIES.—The authority under this section and section 302 to issue any order which requires an enterprise to take affirmative action to correct or remedy any conditions resulting from any violation or activity with respect to which such order is issued includes the authority to require such enterprise—

(1) to make restitution or provide reimbursement, indemnification, or guarantee against loss if the violation or activity involves a reckless disregard for the law or any applicable regulations or prior order of the Director;

(2) to restrict the growth of the enterprise;

(3) to dispose of any asset involved;

(4) to rescind agreements or contracts;

(5) to employ qualified officers or employees (who may be subject to approval by the Director at the direction of the Director); and

(6) take such other action as the Director determines appropriate.

(d) AUTHORITY TO LIMIT ACTIVITIES.—The authority to issue an order under this section or section 302 includes the authority to place limitations on the activities or functions of the enterprise or any director or executive officer of the enterprise.

(e) EFFECTIVE DATE.—A cease-and-desist order under this section shall become effective upon the expiration of the 30-day period beginning on the service of the order upon the enterprise concerned (except in the case of a cease-and-desist order issued upon consent, which shall become effective at the time specified therein), and shall remain effective and enforceable as provided in the order, except to the extent that the order is stayed, modified, terminated, or set aside by action of the Director or a court of competent jurisdiction.

SEC. 302. TEMPORARY CEASE-AND-DESIST ORDERS.

(a) GROUNDS FOR ISSUANCE AND SCOPE.—Whenever the Director determines that any violation, threatened violation, or activity that could result in a rapid depletion of the capital of the enterprise, specified in the notice of

charges served upon the enterprise pursuant to section 301(a), or the continuation thereof, is likely—

(1) to cause insolvency of the enterprise; or

(2) to weaken the condition of the enterprise prior to the completion of the proceedings conducted pursuant to section 301(b),

the Director may issue a temporary order requiring the enterprise to cease-and-desist from any such violation or activity and to take affirmative action to prevent or remedy such insolvency or condition pending completion of such proceedings. Such order may include any requirement authorized under section 301(c).

(b) EFFECTIVE DATE.—An order issued pursuant to subsection (a) shall become effective upon service upon the enterprise and, unless set aside, limited, or suspended by a court in proceedings pursuant to subsection (d), shall remain in effect and enforceable pending the completion of the proceedings pursuant to such notice and shall remain effective until the Director dismisses the charges specified in the notice or until superseded by a cease-and-desist order issued pursuant to section 301.

(c) INCOMPLETE OR INACCURATE RECORDS.—

(1) TEMPORARY ORDER.—If a notice of charges served under section 301(a) specifies that the books and records of the enterprise served are so incom-

plete or inaccurate that the Director is unable, through the normal supervisory process, to determine the financial condition of the enterprise or the details or the purpose of any transaction or transactions that may have a material effect on the financial condition of that enterprise, the Director may issue a temporary order requiring—

(A) the cessation of any activity or practice which gave rise, whether in whole or in part, to the incomplete or inaccurate state of the books or records; or

(B) affirmative action to restore the books or records to a complete and accurate state,

until the completion of the proceedings under section 301.

(2) Effective period.—Any temporary order issued under paragraph (1)—

(A) shall become effective upon service; and

(B) unless set aside, limited, or suspended by a court in proceedings pursuant to subsection (d), shall remain in effect and enforceable until the earlier of—

(i) the completion of the proceeding initiated under section 301 in connection with the notice of charges; or

(ii) the date the Director determines, by examination or otherwise, that the books and records of the enterprise are accurate and reflect the financial condition of the enterprise.

(d) JUDICIAL REVIEW.—Within 10 days after an enterprise has been served with a temporary cease-and-desist order pursuant to this section, the enterprise may apply to the United States district court for the judicial district in which the home office of the enterprise is located, or the United States District Court for the District of Columbia, for an injunction setting aside, limiting, or suspending the enforcement, operation, or effectiveness of the order pending the completion of the administrative proceedings pursuant to the notice of charges served upon the enterprise under section 301(a). Such court shall have jurisdiction to issue such injunction.

(e) ENFORCEMENT BY ATTORNEY GENERAL.—In the case of violation or threatened violation of, or failure to obey, a temporary order issued pursuant to this section, the Director may request the Attorney General of the United States to bring an action in the United States dis-

trict court for the judicial district in which the home office of the enterprise is located or the United States District Court for the District of Columbia for an injunction to enforce such order. If the court finds any such violation, threatened violation, or failure to obey, the court shall issue such injunction.

SEC. 303. HEARINGS AND JUDICIAL REVIEW.

(a) VENUE AND PROCEDURE.—Any hearing under section 301 or 302—

(1) shall be held in the Federal judicial district or in the territory in which the home office of the enterprise is located unless the enterprise consents to another place; and

(2) shall be conducted in accordance with the provisions of chapter 5 of title 5, United States Code.

(b) ISSUANCE OF ORDER.—

(1) IN GENERAL.—After such hearing, and within 90 days after the Director has notified the parties that the case has been submitted to the Director for final decision, the Director shall render the decision (which shall include findings of fact upon which the decision is predicated) and shall issue and serve upon each party to the proceeding

an order or orders consistent with the provisions of this title.

(2) MODIFICATION.—Judicial review of any such order shall be exclusively as provided in subsection (c). Unless a petition for review is timely filed in a court of appeals of the United States as provided in subsection (c), and thereafter until the record in the proceeding has been filed as so provided, the Director may at any time, modify, terminate, or set aside any such order, upon such notice and in such manner as the Director considers proper. Upon such filing of the record, the Director may modify, terminate, or set aside any such order with permission of the court.

(c) JUDICIAL REVIEW.—

(1) COMMENCEMENT.—Any party to any proceeding under subsection (a) may obtain a review of any order served pursuant to such subsection by the filing in the court of appeals of the United States for the circuit in which the home office of the enterprise is located or in the United States Court of Appeals for the District of Columbia Circuit, within 30 days after the date of service of such order, a written petition praying that the order of the Director be modified, terminated, or set aside. The clerk of

the court shall transmit a copy of the petition to the Director.

(2) FILING OF RECORD.—Upon receiving a copy of a petition, the Director shall file in the court the record in the proceeding, as provided in section 2112 of title 28, United States Code.

(3) JURISDICTION.—Upon the filing of a petition, such court shall have jurisdiction, which upon the filing of the record by the Director shall (except as provided in the last sentence of subsection (b)(2)) be exclusive, to affirm, modify, terminate, or set aside, in whole or in part, the order of the Director.

(4) REVIEW.—Review of such proceedings shall be governed by chapter 7 of title 5, United States Code.

(d) NO AUTOMATIC STAY.—The commencement of proceedings for judicial review under subsection (c) shall not, unless specifically ordered by the court, operate as a stay of any order issued by the Director.

SEC. 304. ENFORCEMENT AND JURISDICTION.

(a) ENFORCEMENT.—The Director may request the Attorney General of the United States to bring an action in the United States district court for the judicial district in which the home office of the enterprise is located or the United States District Court for the District of Colum-

bia for the enforcement of any effective notice or order issued under this title, and the court shall have jurisdiction and power to order and require compliance herewith.

(b) LIMITATION ON MODIFICATION.—Except as otherwise provided in this Act, no court shall have jurisdiction to affect, by injunction or otherwise, the issuance or enforcement of any notice or order under this section or to review, modify, suspend, terminate, or set aside any such notice or order.

SEC. 305. CIVIL MONEY PENALTIES.

(a) UNINTENTIONAL VIOLATIONS.—Any enterprise that, without knowledge—

(1) violates any law, rule, or regulation,

(2) violates any final order or temporary order issued pursuant to section 301 or 302,

(3) violates any condition imposed in writing by the Director in connection with the grant of any application or other request by an enterprise, or

(4) violates any written agreement between an enterprise and the Director,

shall be subject to a civil penalty of not more than $5,000 for each day during which such violation continues.

(b) INTENTIONAL VIOLATIONS.—Notwithstanding subsection (a), any enterprise that knowingly commits any violation described in subsection (a) shall be subject to a

civil penalty in an amount not to exceed the applicable maximum amount determined under subsection (c) for each day during which such violation, practice, or breach continues.

(c) MAXIMUM AMOUNT OF PENALTIES.—The maximum daily amount of any civil penalty which may be assessed pursuant to subsection (b) for any violation described in such subsection shall be an amount not to exceed the lesser of $1,000,000 or one percent of the total assets of such enterprise.

(d) PROCEDURES.—

(1) ESTABLISHMENT.—The Director shall establish standards and procedures governing the imposition of civil money penalties under subsections (a) and (b). The standards and procedures—

(A) shall provide for the Director to make the determination to impose the penalty;

(B) shall provide for the imposition of a penalty only after the enterprise has been given notice of, and opportunity for, a hearing on the record; and

(C) may provide for review by the Director of any determination or order, or interlocutory ruling, arising from a hearing.

(2) FINAL ORDERS.—If an enterprise does not request a hearing within 15 days after receipt of a notice of opportunity for hearing, the imposition of a penalty shall constitute a final and unappealable determination. If the Director reviews the determination or order, the Director may affirm, modify, or reverse the determination or order. If the Director does not review the determination or order within 90 days after the issuance of the determination or order, the determination or order shall be final.

(3) FACTORS IN DETERMINING AMOUNT OF PENALTY.—In determining the amount of a penalty under subsection (a) or (b), the Director shall give consideration to such factors as the gravity of the violation, any history of prior violations (including violations occurring before date under subsection (j)), the effect of the penalty on the safety and soundness of the enterprise, any injury to the public, any benefits received, and deterrence of future violations, and any other factors the Director may determine by regulation.

(4) REVIEWABILITY OF IMPOSITION OF PENALTY.—The determination or order of the Director imposing a penalty under subsection (a) or (b) shall

not be subject to review, except as provided in subsection (e).

(e) JUDICIAL REVIEW OF DETERMINATION.—

(1) IN GENERAL.—After exhausting all administrative remedies established by the Director under subsection (d)(1), an enterprise against which the Director has imposed a civil money penalty under subsection (a) or (b) may obtain review of the penalty and such ancillary issues as may be addressed in the notice of the determination to impose a penalty under subsection (d)(1)(A) in the appropriate court of appeals of the United States, by filing in such court, within 20 days after the entry of such order or determination, a written petition praying that the order or determination of the Director be modified or be set aside in whole or in part.

(2) OBJECTIONS NOT RAISED IN HEARING.—A court shall not consider any objection not raised in a hearing conducted pursuant to subsection (d)(1) unless a demonstration is made of extraordinary circumstances causing the failure to raise the objection. If any party demonstrates to the satisfaction of the court that additional evidence, not presented at such hearing, is material and that there were reasonable grounds for the failure to present such evidence at

the hearing, the court shall remand the matter to the Director for consideration of the additional evidence.

(3) SCOPE OF REVIEW.—The review decisions, findings, and determinations of the Director shall be conducted pursuant to section 706 of title 5, United States Code.

(4) ORDER TO PAY PENALTY.—Notwithstanding any other provision of law, the court shall have the authority in any such review to order payment of the penalty imposed by the Director.

(f) ACTION TO COLLECT PENALTY.—If an enterprise fails to comply with a determination or order of the Director imposing a civil money penalty under subsection (a) or (b), after the determination or order is no longer subject to review as provided by subsections (d)(1) and (e), the Director may request the Attorney General of the United States to bring an action in an appropriate district court to obtain a monetary judgment against the enterprise and such other relief as may be available. The monetary judgment may, in the discretion of the court, include any attorneys fees and other expenses incurred by the United States in connection with the action. In an action under this subsection, the validity and appropriateness of

SEC. 307. SUBPOENA AUTHORITY.

(a) IN GENERAL.—In the course of or in connection with any administrative proceeding under this title, the Director shall have the authority—

(A) to administer oaths and affirmations;

(B) to take or cause to be taken depositions;

(C) to issue subpoenas and subpoenas duces tecum; and

(D) to revoke, quash, or modify subpoenas and subpoenas duces tecum issued by the Director.

(b) WITNESSES AND DOCUMENTS.—The attendance of witnesses and the production of documents provided for in this section may be required from any place in any State at any designated place where such proceeding is being conducted.

(c) ENFORCEMENT.—The Director may request the Attorney General of the United States to bring an action in the United States district court for the judicial district in which such proceeding is being conducted, or where the witness resides or conducts business, or the United States District Court for the District of Columbia, for enforcement of any subpoena or subpoena duces tecum issued pursuant to this section. Such courts shall have jurisdiction and power to order and require compliance therewith.

(d) FEES AND EXPENSES.—Witnesses subpoenaed under this section shall be paid the same fees and mileage that are paid witnesses in the district courts of the United States. Any court having jurisdiction of any proceeding instituted under this section by an enterprise may allow to any such party such reasonable expenses and attorneys fees as the court deems just and proper. Such expenses and fees shall be paid by the enterprise or from its assets.

TITLE IV—PRIMACY OF FINANCIAL SAFETY AND SOUNDNESS FOR THE FEDERAL HOUSING FINANCE BOARD

SEC. 401. DUTIES OF FEDERAL HOUSING FINANCE BOARD.

Section 2A(a)(3) of the Federal Home Loan Bank Act (12 U.S.C. 1422a(a)(3)) is amended to read as follows:

"(3) DUTIES.—

"(A) SAFETY AND SOUNDNESS.—The primary duty of the Board shall be to ensure that the Federal Home Loan Banks operate in a financially safe and sound manner.

"(B) OTHER DUTIES.—To the extent consistent with subparagraph (A), the duties of the Board shall also be—

"(i) to supervise the Federal Home Loan Banks;

"(ii) to ensure that the Federal Home Loan Banks carry out their housing finance mission; and

"(iii) to ensure that the Federal Home Loan Banks remain adequately capitalized and able to raise funds in the capital markets.".

SECTION BY SECTION
GOVERNMENT-SPONSORED HOUSING ENTERPRISES
FINANCIAL SAFETY AND SOUNDNESS ACT OF 1991

Sec. 1. SHORT TITLE AND TABLE OF CONTENTS.

The short title of the act is the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991 (the Act).

Sec. 2. CONGRESSIONAL FINDINGS.

Contains finding of Congress regarding the Federal National Mortgage Association (FNMA); the Federal Home Loan Mortgage Corporation (FHLMC (known collectively as the enterprises); and the Federal Home Loan Banks (the Banks). Such findings include the importance of the missions of the FNMA, the FHLMC and the Banks to housing, the need for more effective regulation of the FNMA and the FHLMC, the minimal financial risk that these entities pose to the Federal Government and the lack of federal guarantse behind these entities.

Sec. 3. DEFINITIONS.

Provides definitions for the Act.

TITLE I--SUPERVISION AND REGULATION OF FNMA AND FHLMC

Subtitle A--Establishment of Financial Safety and Soundness Regulator

Sec. 101. ESTABLISHMENT OF OFFICE OF SECONDARY MARKET EXAMINATION AND OVERSIGHT.

Establishes, effective January 1, 1992, the Office of Secondary Market Examination and Oversight (the Office) in the Department of Housing and Urban Development (HUD).

Sec. 102. DIRECTOR.

Provides that the Director of the Office shall be appointed by the President with the advice and consent of the Senate from among individuals that are citizens and that have experience in financial management or oversight. An individual who has served with either the FNMA or the FHLMC in an executive capacity at any point during the five years prior to the appointment as Director is ineligible to be appointed.
Provides that the Director shall serve for a term of five years

and any vacancy in the office of director shall be filled in the same manner as the original appointment but only for the remainder of the original director's term.

Provides for a deputy director, who shall be appointed by the President with the advise and consent of the Senate. The Deputy Director shall have such powers and duties as are delegated by the Director and shall serve as director in the event of the Director's absence death, or resignation until a successor director can be appointed.

Sec. 103. AUTHORITY OF DIRECTOR.

Provides that the Director shall have the exclusive authority (1) to establish the risk based capital standards for new programs programs that are significantly and materially different from programs that the enterprises are engaged in or have engaged in on or prior to the date of enactment, except that any program undertaken on a temporary or limited basis on the date of an enactment is a new program, if carried out on a permanent or expanded basis), (2) to examine the enterprises, (3) to appoint a conservator, (4) to take any enforcement actions, and (5) to approve the payment of dividends under some circumstances.

Provides that any authority not specifically listed, including the authority to establish rules and regulations, is subject to the review of the Secretary and is not subject to the review or approval of any other officer of HUD.

Sec. 104. PERSONNEL

Provides that the Director shall appoint and fix the compensation of the officers and employees of the office without regard to civil service requirements.

Sec. 105. FUNDING.

Provides that the Director may assess and collect sufficient funds from the enterprises to pay for the operations of the Office and any examinations. Such funds shall be placed in a fund known as the Secondary Market Examination and Oversight Fund and amounts from such fund shall be available to the extent provided in appropriations acts.

Sec. 106. ANNUAL REPORTS.

Provides that the Director shall report annually, by April 15th, to Congress on the financial status of the enterprises, the actions of the Director to implement the provisions of the Act, and any legislation needed to enhance the safety and soundness of the enterprises.

Sec. 107. REGULATIONS AND ORDERS.

Requires the Director to use regulations to carry out the duties of the Director and the Act.

Subtitle B--Amendments to Other Acts

Sec. 121. AMENDMENTS TO FEDERAL NATIONAL MORTGAGE ASSOCIATION CHARTER ACT.

Amends the charter of the FNMA to make technical changes to delete obsolete and out-of-date provisions and to provide for conforming changes.

Deletes references to the authority of the Secretary of HUD with respect to the approval of dividends and to provide that the Director require the FNMA to report prior to declaring or paying dividends.

Deletes requirement that FNMA maintain a 15:1 obligations to capital ratio.

Requires that one of the five directors of the FNMA appointed by the President represent the interest of consumers or low income residente.

Limits the compensation of executive officers (the chief financial officer, the chief executive officer and any individual who participates in major policy making) to a compensation level that is no more than officers in comparable positions at the FHLMC are making on July 1, 1991, plus adjustments based on the adjustments made to civil service salaries. This limitation would only apply to new personnel or to current personnel if they enter into a new employment contract after enactment of the Act.

Provides the Secretary of HUD shall have general regulatory power over the FNMA except for those authorities specifically granted to the Director.

Requires the Secretary to ensure that a reasonable portion of the FNMA's mortgage purchases be related to the national goal of providing adequate housing for low- and moderate-income families, but with a reasonable economic return to the FNMA Defines a low-income family as one whose income does not exceed 80 percent of median and a moderate-income family as one whose income does not exceed 100 percent of median.

Prohibits the FNMA from carrying out new programs without the prior approval of the Secretary and only upon a determination that the new program conforms with the requirements and purposes of the charter.

Requires the FNMA to report to the Secretary as the Secretary requires and requires the secretary to report annually to Congress.

Expands the current GAO audit authority to include all financial transactions of the FNMA.

Requires the FNMA to report quarterly to the Director on the financial condition of the corporation. Authorizes the Director to require additional and special reports.

Requires the FNMA to reserve from general surplus an amount equal to 20 percent of any dividends paid by the FNMA during the preceding year to be used for low-income rental housing including limited equity cooperatives. Prohibits the FNMA from increasing fess to contribute to the program. The FNMA is not required to reserve such funds whenever it fails to meet either the risk based capital level or the minimum capital level. The board of directors of the FNMA shall establish the requirements for housing under this affordable housing program. This program shall provide that the funds shall be used for specific projects selected by the board of directors, that the housing assisted under the program remain available to low-income persons during its useful life, that the housing meet certain targeting requirements and that the projects assisted be geographically diverse. The Secretary of HUD is required to monitor the housing assisted under the program to ensure continued compliance with the low-income use restrictions. The FNMA is required to report to the Secretary annually on its activities under this program.

Sec. 122. AMENDMENTS TO FEDERAL HOME LOAN MORTGAGE CORPORATION ACT.

Amends the charter of the FHLMC to make technical changes to delete obsolete and out-of-date provisions, including provisions requiring the Federal Home Loan Banks to hold nonvoting common stock of the FHLMC, and to provide for conforming changes.

Adds definitions for low-income family (80% of median or below) and moderate-income family (between 100% and 8% of median).

Requiras that one of the five directors of the FHLMC appointed by the Prasident represent the interest of consumers or low income residents.

Provides the Secretary of HUD shall have general regulatory power over the FHLMC except for those authorities specifically granted to the Director.

Requires the Secretary to ensure that a rsasonable portion of the

FHLMC's mortgage purchases be related to the national goal of providing adequate housing for low- and moderate-income families, but with a reasonable economic return to the FHLMC.

Deletes references to the authority of the Secretary of HUD with respect to the approval of dividends and provides that the Director may require the FHLMC to report prior to declaring dividends. Prohibits the FHLMC from making any dividend payment that would cause the Corporation to fail to meet either the risk based capital standard or the minimum capital level.

Deletes the authority of the Secretary of HUD to examine and audit the books and financial transactions of the Corporation, and deletes the Secretary s authority to approve stock issuances.

Prohibits the FHLMC from carrying out new programs without the prior approval of the Secretary and only upon a determination that the new program conforms with the requirements and purposes of the charter.

Deletes 15:1 obligation to capital ratio.

Limits the compensation of executive officers (the chief financial officer, the chief executive officer and any individual who participates in major policy making) to no more than such officers in comparable positions at FHLMC are making on July 1, 1991, plus adjustments based on the adjustments made to civil service salaries. This limitation would only apply to new personnel or to current personnel if they enter into a new employment contract after enactment of the Act.

Requires the FHLMC to report to the Secretary as the Secretary requires and requires the Secretary to report annually to Congress.

Requires the FHLMC to report quarterly to the Director on the financial condition of the corporation. Authorizes the Director to require additional and special reports.

Requires the FHLMC to reserve from general surplus an amount equal to 20 percent of any dividends paid by the FHLMC during the preceding year to be used for low-income rental housing including limited equity cooperatives. Prohibits the FHLMC from increasing fees to contribute to the program. The FHLMC is not required to reserve such funds whenever it fails to meet either the risk based capital level or the minimum capital level. The board of directors of the FHLMC shall establish the requirements for housing under this affordable housing program. This program shall provide that the funds shall be used for specific projects selected by the board of directors, that the housing assisted under the program remain available to low-income persons during its useful life, that the housing meet certain targeting

requirements, and that the projects assisted be geographically diverse. The Secretary of HUD is required to monitor the housing assisted under the program to ensure continued compliance with the low-income use restrictions. The FHLMC is required to report to the Secretary annually on its activities under this program.

Sec. 123. AMENDMENTS TO TITLE 5 OF THE UNITED STATES CODE.

Amends Title 5 of the United States Code to make the Director at Level II of the Executive Schedule and the Deputy Director at Level III of the Executive Schedule.

Subtitle C--Implementation

Sec. 131. IMPLEMENTATION.

Requires that the Secretary of HUD and the Director issue regulations implementing this title within 18 months of enactment of this Act. Such regulations shall clearly delineate the responsibilities and authority of the Secretary and the Director pursuant to the amendments made by this title.

TITLE II--REQUIRED CAPITAL LEVELS FOR FNMA AND FHLMC AND SPECIAL ENFORCEMENT POWERS

Sec. 201. RISK-BASED CAPITAL LEVELS.

Requires the Secretary to set risk-based capital levels for the enterprises within one year of enactment of the Act.

Requires that the risk-based capital levels be an amount of regulatory capital (core capital (par value of outstanding common stock, par value of outstanding preferred stock, paid in capital plus retained earnings) plus reserves) equal to the amount of capital required by a credit risk stress test and by an interest rate stress test plus an amount for management and operations risk and new program risk.

Defines the credit risk to be a nationwide occurrence of default rates and loss severity equal to the enterprises worst three year experience on 30 year fixed rate mortgages in a standard region (a state or 2 or more contiguous states that have no less than 5 percent of the population of the United States) for which reliable data exists. The enterprises would be required to have sufficient capital to withstand such a circumstance for eight years.

Defines the interest rate risk to be either a 50 parcent increase (not to exceed 500 basis points) over a 12-month period of interest rates on 10 year Treasury obligations or a similar decrease and the maintenance of such rates for seven years.

Requires the enterprises to maintain an additional amount of capital for management and operations risk equal to 20 percent of the amounts needed for interest and credit risk and provides that the Director can adjust such requirement as appropriate to reflect actual management and operations risk.

Requires the enterprises to have sufficient regulatory capital to cover any amounts required by the Director for new programs.

Sec. 202. MINIMUM CAPITAL LEVELS.

Establishes that the minimum capital level for each enterprise shall be (1) an amount of marked-to-market equity of the enterprise equal to 2.0 percent of the on-balance sheet assets of the enterprise, and 1.0 percent of the unpaid principal balance of off-balance sheet obligations of the enterprise with respect to residential mortgages and (2) an amount of core capital equal to 1.5 percent of the on-balance sheet assets of the enterprise, and 0.5 percent of the unpaid principal balance of off-balance sheet obligations of the enterprise with respect to residential mortgages.

The term "marked-to-market equity of the enterprise" means the difference between the current market value of on- and off-balance sheet assets of the enterprise; and the current market value of on-and off-balance sheet obligations of the enterprise.

Sec. 203. CRITICAL CAPITAL LEVELS.

Establishes that critical capital is one-half of marked-to-market minimum capital and one-half of the amount of core capital needed to meet minimum capital.

Sec. 204. ENFORCEMENT LEVELS.

Requires the Director to classify the enterprises according to the enforcement levels.

An enterprise is in Level I if the enterprise maintains an amount of regulatory capital that meets or exceeds the risk-based capital level and the enterprise meets or exceeds the minimum capital level for the enterprise.

An enterprise shall be classified as within Level II if the enterprise maintains an amount of regulatory capital that is less than the risk-based capital level established for the enterprise and the enterprise equals or exceeds the minimum capital level for the enterprise.

An enterprise shall be classified as within Level III if the enterprise does not equal or exceed the minimum capital level for the enterprise and equals the enterprise or exceeds the critical

capital level for the enterprise.

An enterprise shall be classified as within Level IV if the enterprise does not equal or exceed the critical capital level for the enterprise.

If the Director determines, in writing, that an enterprise is taking any action not approved by the Director that could result in a rapid depletion of capital or that the value of the property securing the mortgages held or set aside by the enterprise has decreased significantly, the Director may reclassify the enterprise to a lower enforcement level Such reclassification would allow a Level I enterprise to be classified as within Level II or III; a Level II enterprise as within Level III or IV; and a Level III enterprise as within Level IV.

The Director shall determine the classification of the enterprises at least quarterly

Sec 205. MANDATORY SUPERVISORY ACTIONS APPLICABLE TO ENTERPRISES WITHIN LEVEL II.

Requires the Director to provide written notice to the Congress and to the enterprise that the enterprise is within Level II; that the enterprise is subject to the provisions of this section; and stating the reasons for the classification of the enterprise within Level II.

Requires an enterprise within Level II to consult with the Director and submit to the Director a capital restoration plan and, after approval, to carry out the plan.

Prohibits an enterprise within Level II from making any payment of dividends that would result in the enterprise being reclassified as within Level III or IV.

Requires the Director to reclassify immediately an enterprise within Level II as within Level III if the enterprise does not submit the required capital restoration plan; or if the Director determines thet the enterprise has failed to make, in good faith, all reasonable efforts necessary to comply with the capital plan and fulfill the schedule for the plan approved by the Director.

This section shall take effect upon the expiration of the 2-year period beginning on the date of the enactment of this Act.

Sec. 206. SUPERVISORY ACTIONS APPLICABLE TO ENTERPRISES WITHIN LEVEL III.

Requires an enterprise within Level III shall submit to the Director a capital restoration plan and, after approval, to carry out the plan.

Prohibits an enterprise within Level III from making any payment of dividends that would result in the enterprise being reclassified as within Level IV. An enterprise within Level III may make any other payment of dividends only if the Director approves the payment before the payment. The Director may approve such a payment of dividends only if the Director determines that the payment will enhance the ability of the enterprise to meet the risk-based capital level and the minimum capital level for the enterprise or is otherwise in the public interest.

Prohibits an enterprise within Level III from undertaking an activity subject to the approval of the Secretary of HUD under the enterprise's charter except with tha additional approval of the Director.

Requires the Director to reclassify an enterprise within Level III as within Level IV if the enterprise does not submit the required capital restoration plan or the Director determines that the enterprise has failed to make, in good faith, all reasonable efforts necessary to comply with the capital plan and fulfill the schedule for the plan approved by the Director.

Authorizes the Director to limit any increase in, or order the reduction of, any obligations of the enterprise, including off-balance sheet obligations; limit or prohibit the growth of the assets of the enterprise or require contraction of the assets of the enterprise; prohibit the enterprise from making any payment of dividends; require the enterprise to issue new capital in any form and in any amount sufficient to provide for the reclassification of the enterprise as within Level II; require the enterprise to terminate, reduce, or modify any activity that the Director determines creates excessive risk to the enterprise; and appoint a conservator for the enterprise.

This section shall take effect upon the expiration of the 1-year period beginning on the date of this Act.

Sec. 207. MANDATORY APPOINTMENT OF CONSERVATOR FOR ENTERPRISES WITHIN LEVEL IV.

Requires the Director to provide written notice to the COngress and to the enterprise that the enterprise is within Level IV and that a conservator shall be appointed for the enterprise pursuant

to this section; and requires the Director to appoint a conservator for the enterprise within 30 days of such notice.

Such a conservator shall have all of the mandatory and discretionary powers of the Director and may undertake an activity subject to the approval of the Secretary under the FNMA charter or the FHLMC charter only with the additional approval of the Director.

This section shall take effect on January 1, 1992.

Sec. 208. CONSERVATORSHIP.

Authorizes the Director to appoint a conservator for an enterprise upon a determination that the enterprise is not likely to pay its obligations in the normal course of business; that the enterprise has incurred or is likely to incur losses that will deplete all or substantially all of its core capital and there is no reasonable likelihood that the enterprise will replenish its core capital without Federal assistance; that the enterprise has concealed books, papers, records, or assets of the enterprise, or refused to submit books, papers, records, or information regarding the affairs of the enterprises for inspection to the Director upon request; or that the enterprise is classified within Level III.

Requires the Director to provide written notice to the Congress and to the enterprise that a conservator will be appointed for the enterprise under this section before appointing a conservator under this section.

Provides that an enterprise for which a conservator is appointed may bring an action in the United States district court for the judicial district in which the home office of such enterprise is located or in the United States District Court for the District of Columbia, for an order requiring the Director to terminate the appointment of the conservator. Such an action may be commenced only before the expiration of the 20-day period beginning upon the appointment of the conservator. A decision of the Director to appoint a conservator may be set aside only if the court finds that the decision was arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with applicable laws. Except as provided in this subsection, no court may take any action regarding the removal of a conservator or otherwise restrain or affect the exercise of powers or functions of a conservator.

Authorizes a conservator to request that any judicial action or proceeding to which the conservator or the enterprise is or may become a party be stayed for a period of 45 days commencing upon the appointment of the conservator. Upon petition, the court shall grant such stay as to all parties.

Authorizes the Director to replace a conservator without notice or hearing with another conservator. The Director may examine and supervise any enterprise in conservatorship during the period in which the enterprise continues to operate as a going concern.

Authorizes the Director to terminate a conservatorship when the Director determines it is in the public interest, and the Director shall terminate a mandatory conservatorship upon a determination that the enterprise equals or exceeds the minimum capital level for the enterprise. The Director may not impose any terms, conditions, or limitations on the transaction of business of an enterprise whose conservatorship is terminated under this paragraph.

Provides that a conservator shall have all the powers of the shareholders, directors, and officers of the enterprise under conservatorship and may operate the enterprise in the name of the enterprise. A conservator is subject to any rules regulations, and orders issued from time to time by the Director. The Director may require a conservator to set aside and make available for payment to creditors any amounts that the Director determines may safely be used for such purpose. All creditors who are similarly situated shall be treated in a similar manner.

Provides that a conservator (other than the Director) and professional employees (other than Federal employees) appointed to represent or assist the conservator may be compensated for activities conducted as conservator. Compensation may not be provided in amounts greater than the compensation paid to employees of the Federal Government for similar services, except that the Director may provide for compensation at higher rates but not in excess of rates prevailing in the private sector), if the Director determines that compensation at higher rates is necessary in order to recruit and retain competent personnel. All expenses of a conservatorship shall be paid by the enterprise and shall be secured by a lien on the enterprise, which shall have priority over any other lien.

Sec. 209. CAPITAL RESTORATION PLANS.

Requires that each capital restoration plan set forth a feasible plan for the enterprise to promptly equal or exceed the minimum capital level for the enterprise and for promptly restoring the level of regulatory capital of the enterprise subject to the plan to not less than the risk-based capital level for the enterprise. Each such plan shall specify the level of capital the enterprise will achieve and maintain; describe the actions that the enterprise will take to equal or exceed the relevant capital measures; establish a schedule for promptly completing the capital restoration plan; specify the types and levels of activities in which the enterprise will engage during the term of

the capital restoration plan; and describe the actions that the enterprise will take to comply with any mandatory and discretionary requirements imposed under this title.

Requires that such plan be submitted to the Director not more than 30 days after the enterprise is notified that a plan is required The Director may extend tha deadline, in writing and for a certain time, to the extent that the Director determines necessary

Requires that the Director approve or disapprove the plan not later than 30 days after submission of the plan. The Director may extend the period for approval or disapproval for a single additional 30-day period.

Requires the Director to notify any enterprise submitting a plan in writing of the approval or disapproval of the plan and of any extension of the period for approval or disapproval.

Sec. 210. JUDICIAL REVIEW OF DIRECTOR ACTION.

Provides that a person aggrieved by an action of the Director under this title (except the mandatory appointment of a conservator) may obtain review of the action by filing, within 10 days after receiving notice of the Director's action, a written petition requesting that the action of the Director be modified, terminated, or set aside. Such a petition shall be filed in the United States Court of Appeals for the District of Columbia Circuit or the United States Court of Appeals for the circuit in which the enterprise maintains its principal office.

The term "person aggrieved by an action of the Director" means, with respect to an enterprise within Level I, II, or III, the enterprise that is the subject of a mandatory or discretionary supervisory action taken under this title.

Provides that an action taken by the Director may be modified, terminated, or set aside only if the court finds, on the record on which the Director acted, that the action of the Director was arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with applicable laws. Except as provided in this section, no court shall have jurisdiction to affect, by injunction or otherwise, the issuance or effectiveness of any action of the Director under this section or to review, modify, suspend, terminate, or set aside such action.

Sec. 211. EXAMINATIONS.

Requires that the Director annually examine each enterprise to determine the condition of the enterprise for the purpose of ensuring its financial safety and soundness.

Authorizes the Director to conduct additional examinations when the Director determines that an examination is necessary to determine the condition of an enterprise for the purpose of ensuring its financial safety and soundness. Requires that examinations be conducted only by the Director and officers and employees of the Office. Prohibits the Director from basing any decision or action primarily upon information provided by technical experts or other entities that are not officers or employees of the Office. Authorizes the Director to obtain the services of any technical experts the Director considers necessary and appropriate to provide temporary technical assistance relating to examinations. Requires the Director to describe, in the public record of each examination the nature and extent of any such temporary technical assistance.

Authorizes the Director to administer oaths and affirmations; take and preserve testimony under oath; and issue subpoenas requiring the attendance and testimony of witnesses and the production of evidence in connection with any examinations.

Authorizes the Director to request that the Comptroller General examine the enterprise solely to provide an independent determination regarding the safety and soundness of the enterprise. Such examination shall be conducted at a time and in a manner that results in minimal disruption to the normal business activities of the enterprise. The Comptroller General may obtain the services of technical experts in the same manner as the Director may obtain such services under subsection (c) except that any entity that assists the Director in examining an enterprise may not concurrently assist the Comptroller General to examine the enterprise under this subsection.

Sec. 212. CIVIL MONEY PENALTIES FOR FAILURE TO REPORT.

Authorizes the Director to impose a civil money penalty on any enterprise that maintains reasonable procedures designed to prevent errors and unintentionally submits to the Director (i) any false or misleading report or (ii) any false or misleading information; or submits any report minimally late. The amount of a penalty under this paragraph, as determined by the Director, may not exceed $500 per day for each day during which such failure continues or such false or misleading information is not corrected.

Authorizes the Director to impose a civil money penalty on any enterprise that fails to make any report within the period of time established by the Director for submission of the report. The amount of the penalty, as determined by the Director, may not exceed $10,000 per day for each day during which such failure continues.

Authorizes the Director to impose a civil money penalty on any enterprise that submits to the Director any false or misleading report or information with actual knowledge of inaccuracy, deliberate ignorance of inaccuracy, or reckless disregard for accuracy. The amount of the penalty may not exceed $1,000,000 or 1 percent of total assets of the enterprise, whichever is less, per day for each day during which such failure continues or such false or misleading information is not corrected.

Requires the Director to establish standards and procedures governing the imposition of civil money penalties. Such standards and procedures shall provide for the Director to make the determination to impose the penalty; shall provide for the imposition of a penalty only after the enterprise has been given notice of, and opportunity for, a hearing on the record; and may provide for review by the Director of any determination or order, or interlocutory ruling, arising from a hearing.

Provides for such a determination to become a final order and for administrative and judicial appeal of such order and for collection of such penalty.

In determining the amount of a penalty, the Director shall give consideration to such factors as the gravity of the violation; any history of prior violations; the effect of the penalty on the safety and soundness of the enterprise; any injury to the public; any benefits received; and deterrence of future violations, and any other factors the Director may determine by requlation.

TITLE III--CEASE-AND-DESIST ORDERS AGAINST FNMA AND FHLMC

Sec. 301. CEASE-AND-DESIST PROCEDURES.
Authorizes the Director to issue and serve upon an enterprise a notice of charges if, in the determination of the Director, the enterprise is engaging or has engaged, or the Director has reasonable cause to believe that the enterprise is about to engage, in any activity that could result in a rapid depletion of the core capital of the enterprise; or the enterprise is violating or has violated, or the Director has reasonable cause to believe that the enterprise is about to violate any law, rule or regulation, any condition imposed in writing by the Director in connection with the granting of any application or other request by the enterprise, or any written agreement entered into by the enterprise with the Director.

Provides for a hearing on the charges to determine if a cease and desist order should issue.

Authorizes the Director to issue a cease end desist order if the Director finds that any violation or activity that could result

in a rapid depletion of the capital of the enterprise specified in the notice of charges has been established.

Authorizes the Director to include in such an order an order which requires an enterprise to cease and desist from such violation or to take affirmative action to correct or remedy any conditions resulting from any violation or activity with respect to which such order is issued, including an order requiring such enterprise to make restitution or provide reimbursement, indemnification, or guarantee against loss if the violation or activity involves a reckless disregard for the law or any applicable regulations or prior order of the Director; to restrict the growth of the enterprise; to dispose of any asset involved; to rescind agreements or contracts; to employ qualified officers or employees (who may be subject to approval by the Director at the direction of the Director); and take such other action as the Director determines appropriate. The authority to issue an order under this section includes the authority to place limitations on the activities or functions of the enterprise or any director or executive officer of the enterprise.

Sec. 302. TEMPORARY CEASE AND DESIST ORDERS.

Authorizes the Director to issue a temporary cease and desist order whenever the Director determines that any violation, threatened violation, or activity that could result in a rapid depletion of the capital of the enterprise as specified in a notice for a cease and desist order is likely to cause insolvency of the enterprise, or to weaken the condition of the enterprise prior to the completion of the cease and desist proceedings. Authorizes the Director to take affirmative action to prevent or remedy such insolvency or condition pending completion of such proceedings. Such an order is effective immediately.

Authorizes the Director to issue a temporary cease and desist order if a notice of charges for a cease and desist order specifies that the books and records of the enterprise served are so incomplete or inaccurate that the Director is unable, through the normal supervisory process, to determine the financial condition of the enterprise or the details or the purpose of any transaction or transactions that may have a material effect on the financial condition of that enterprise. Such a temporary order may require the cessation of any activity or practice which gave rise, to the incomplete or inaccurate state of the books or records or affirmative action to restore the books or records to a complete and accurate state, until the completion of the cease and desist proceedings.

Providas for judicial review of a temporary cease and desist order in the United States district court for the judicial district in which the home office of the enterprise is located, or the United States District Court for the District of Columbia.

In such an action, which must be initiated within 10 days of the issuance of the order, the enterprise may request an injunction setting aside, limiting, or suspending the enforcement, operation, or effectiveness of the order pending the completion of the administrative proceedings pursuant to the notice of charges for the cease and desist order. Provides for the enforcement of a temporary cease and desist order by the Attorney General at the request of the Director

Sec. 303. HEARINGS AND JUDICIAL REVIEW.

Provides that any hearing on a cease and desist order or a temporary cease and desist order by held in the Federal judicial district or in the territory in which the home office of the enterprise is located unless the enterpriee consents to another place.

Requires the Director to render a decision within 90 days after such hearing and to issue and serve upon each party to the proceeding an order or orders consistent with the provisions of this title.

Provides for judicial review of the Director's action in the court of appeals of the United States for the circuit in which the home office of the enterprise is located or in the United States Court of Appeals for the District of Columbia Circuit, within 30 days after the date of service of such order The commencement of proceedings for judicial review shall not unless specifically ordered by the court, operate as a stay of any order issued by the Director.

Sec. 304. ENFORCEMENT AND JURISDICTION.

Provides that the Director may request the Attorney General to bring an action in the United States district court for the judicial district in which the home office of the enterprise is located or the United States District Court for the District of Columbia for the enforcement of any effective cease and desist notice or order and the court shall have jurisdiction and power to order and require compliance herewith Except as otherwise provided in this Act, no court shall have jurisdiction to affect, by injunction or otherwise, the issuance or enforcement of any notice or order under this section or to review, modify, suspend, terminate, or set aside any such notice or order.

Sec. 305. CIVIL MONEY PENALTIES.

Provides that any enterprise that, without knowledge, violates any law, rule or regulation, violates any final order or temporary cease and desist order, violates any condition imposed in writing by the Director in connection with the grant of any application or other request by an enterprise, or violates any

written agreement between an enterprise and the Director, shall be subject to a civil penalty of not more than $5,000 for each day during which such violation continues.

Provides any enterprise that knowingly commits any violation described above shall be subject to a civil penalty in an amount not to exceed the lesser of $1,000,000 or one percent of the total assets of such enterprise for each day during which the violation, practice or breach continues.

Requires the Director to establish standards and procedures governing the imposition of civil money penalties. Such standards and procedures shall provide for the Director to make the determination to impose the penalty; shall provide for the imposition of a penalty only after the enterprise has been given notice of, and opportunity for, a hearing on the record; and may provide for review by the Director of any determination or order, or interlocutory ruling, arising from a hearing.

Provides that such a determination to become a final order and for administrative and judicial appeal of such order and for collection of such penalty.

In determining the amount of a penalty, the Director shall give consideration to such factors as the gravity of the violation, any history of prior violations, the effect of the penalty on the safety and soundness of the enterprise, any injury to the public, any benefits received, and deterrence of future violations, and any other factors the Director may determine by regulation.

Sec. 306. NOTICE OF SERVICE.

Provides that any service required or authorized to be made by the Director under this title be made by registered mail, or in such other manner reasonably calculated to give actual notice as the Director may by regulation or otherwise provide.

Sec. 307. SUBPOENA AUTHORITY.

Authorizes the Director, in the course of or in connection with any administrative proceeding under this title, to administer oaths and affirmations; to take or cause to be taken depositions; to issue subpoenas and subpoenas duces tecum; and to revoke, quash, or modify subpoenas and subpoenas duces tecum issued by the Director.

Provides that the attendance of witnesses and the production of documents provided for in this section may be required from any place in any State at any designated place where such proceeding is being conducted.

Authorizes the Director to request the Attorney General of the United States to bring an action in the United States district court for the judicial district in which such proceeding is being conducted, or where the witness resides or conducts business, or the United States District Court for the District of Columbia, for enforcement of any subpoena or subpoena duces tecum issued pursuant to this section. Such courts shall have jurisdiction and power to order end require compliance therewith.

Provides that witnesses subpoenaed under this section shall be paid the same fees and mileage that are paid witnesses in the district courts of the United States. Any court having jurisdiction of any proceeding instituted under this section by an enterprise may allow to any such party such reasonable expenses end attorneys fees as the court deems just and proper. Such expenses and fees shall be paid by the enterprise or from its assets.

TITLE IV--PRIMACY OF FINANCIAL SAFETY AND SOUNDNESS FOR THE FEDERAL HOUSING FINANCE BOARD

Sec. 401. DUTIES OF FEDERAL HOUSING FINANCE BOARD.

Amends the Federal Home Loan Bank Act to provide that the primary duty of the Federal Housing Finance Board shall be to ensure that the Federal Home Loan Banks operate in a financially safe and sound manner.

OPENING STATEMENT

CHAIRMAN HENRY B. GONZALEZ

JULY 18, 1991

Today we begin the second stage of the process of providing for the financial safety and soundness of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal Home Loan Banks and addressing potential regulatory gaps with respect to these entities.

At our hearings in May we were presented with testimony and reports by the Department of Treasury, the Department of HUD, the Congressional Budget Office and the General Accounting Office. This testimony and these studies uniformly stated that Fannie Mae and Freddie Mac pose no immediate risk to the Federal Government and that the Banks pose minimal risk. However, all of the studies agree that the regulatory scheme for these enterprises needs to be reformed to ensure that the risks to the Government stay small.

To this end, Congresswoman Roukema, Congressman Wylie and I introduced legislation on Tuesday to address regulatory gaps and ensure the continued financial viability of the enterprises. I will not go into detail about the legislation at this point; however, I do want to highlight some important provisions in the bill.

First, this legislation follows the Department of Treasury recommendation and provides for an financial safety and soundness regulator in the Department of Housing and Urban Development. This requlator would be responsible for ensuring that Fannie Mae and Freddie Mac remain financially safe and sound by eetting and enforcing capital standards for these enterprises.

Second, the regulation updates the capital requirements for Fannie Mae and Freddie Mac. The current requirement does not take into account the extensive off-balance sheet liabilitiee of the enterprises. Risk-baeed capital levels for Fannie and Freddie will be determined through the application of stress tests the parameters of which are defined in the bill.

Third, the bill will define Fannie's and Freddie's role in providing low and moderate income housing by adding definitions for low income housing (80% of median income) and moderate income housing (100% of modian income) and by requiring that Fannie Mae and Freddie Mac each annually devote an amount equal to 20% of their prior year's dividends to a program to provide low income rental housing.

Finally, the bill would limit the compensation that may be provided to the executives of Fannie and Freddie.

I expect our witnesses today and tomorrow to comment on these and other provisions in the bill. This bill is a start, and the

purpose of the hearing today is to obtain the insight of the witnesses so that they can be considered as we begin markup of the bill next week.

7/18/91

TESTIMONY OF
CONGRESSMAN FLOYD H. FLAKE
BEFORE THE
SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT
HEARING ON
H.R. 2900, LEGISLATION TO PROVIDE FOR THE SAFETY AND SOUNDNESS OF GOVERNMENT SPONSORED ENTERPRISES

Mr. Chairman, today begins a process to alter the regulatory structure of Government Sponsored Enterprises (GSEs). The hearing today and tomorrow and the legislation that we will shortly consider is about two issues: (1) the risk to the government and the taxpayers from the operations of GSEs; and (2) national housing policy and the GSEs' role in fulfilling that policy. The efforts of the GSEs in protecting the taxpayer against liability and their efforts to provide affordable housing are indeed commendable. Through these agencies, the Congress has made hundreds of billions of dollars available to assist Americans with homeownership opportunities.

The Chairman and his staff have a done a most commendable job in drafting H.R. 2900, especially given the responsibilities of the Banking Committee in recent weeks. It is my understanding that there are four separate areas where issue has been taken by affected parties regarding this legislation. It is my hope that the witnesses and the Chairman will clarify the intent of the language contained in these provisions. These areas include: (1) the discretion of the regulator to unilaterally determine the rate and capital standards for management and operations risk, as opposed to a fixed capital level; (2) the need for multiple approval from regulators for new financial instruments by GSEs and the competitive problems that may arise from this requirement; (3) the potential impact of a dividend tax for housing purposes and its potential impact on capital formation and a potential decrease in overall funding for affordable housing programs; and (4) Salary caps for GSE employees.

I look forward to the testimony of the witnesses and to moving forward with this vitally needed legislation.

H0004ST.2/dL

OPENING STATEMENT OF
CONGRESSWOMAN MAXINE WATERS
HEARING ON GOVERNMENT-SPONSORED
ENTERPRISES (GSEs)

July 18, 1991

Mr. Chairman, thank you for calling this hearing today. I am especially grateful to you for having hearings so soon after you have introduced legislation on government sponsored housing enterprises. These hearings will give us a chance to review your proposal and hear testimony about the effects the changes will have on housing policy. This will give members of this subcommittee, particularly new members like me, a better framework as we proceed with marking up the legislation next week.

As I read through your proposal, the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991, I was pleased with several components. Unlike so many financial institutions, the GSEs are in good financial condition overall. Nonetheless, there has been testimony before this Committee suggesting that under certain economic conditions, the GSEs could have serious difficulties. It is exceedingly responsible that this legislation applies the lessons of the past and prescribes several

precautionary measures that will reduce the likelihood of trouble for the GSEs in the future.

For example, the bill instructs the Secretary of HUD to establish risk-based capital standards within one year of the enactment of this Act. Risky lending has undone even the most sound financial institutions in this country. Risk-based standards could have saved many banks and savings and loans from default. It is certainly a wise practice for GSEs.

The bill enforces these standards by regulating the activities of enterprises based on their level of capital. A Level IV enterprise, the lowest rating, would automatically be placed in conservatorship. Again, this represents a forward-looking reform designed to limit the potential cost to the taxpayers.

I was also pleased to note the limitations this legislation places on the incomes of executive officers. Clearly, something had to be done to limit the ridiculous salaries that are being paid to top GSE official. Few of our constituents would understand multi-million dollar contracts for GSE employees.

Finally, I would like to raise one point which was raised at a hearing of this Subcommittee yesterday on HUD's report on removing barriers to affordable

housing. One witness at the hearing, John Payne from Rutgers Law School and a long-time housing advocate, indicated that there were in fact restrictive features of the secondary mortgage market system. I intend to follow up on his comments but I would be interested to hear today concerns people have about any restrictive effects GSE policy have on affordable housing. Clearly, we will want to correct any negative impact on the housing market, especially for low-income people.

I hope that in the course of this discussion we will be sure to address any areas which need fixing within GSEs to insure the maximum involvement in low-income housing. Thank you Mr. Chairman.

OPENING REMARKS OF HONORABLE MARGE ROUKEMA
HOUSING SUBCOMMITTEE
GOVERNMENT SPONSORED ENTERPRISES

7/18/91

Mr. Chairman, I want to commend you for holding this hearing today as we begin the process of considering H.R. 2900, a bill to provide for the safety and soundness and regulation of the GSEs for which I am pleased to join the Chairman as a sponsor.

Today, we will receive testimony from the Treasury, HUD, FREDDIE MAC and FANNIE MAE.

As the Chairman knows, FREDDIE MAC and FANNIE MAE were chartered by the Congress as stockholder-owned, privately managed corporations to prov de an affordable and adequate supply of mortgage credit to those citizens seeking the American dream of homeownership. We continue to support this objective.

I suppose when looking at the immediate past and current performance of both FANNIE and FREDDIE, the old adage, "if it ain't broke, don't fix it" should apply

Clearly, FREDDIE and FANNIE are working. Recent highly impressive quarterly earnings reports by both organizations especially in light of the general state of our real estate and mortgage markets, and the troubles our banks, thrifts and now some of our insurance companies, are having with their real estate portfolios, is a great credit to the leadership of Mr. Johnson and Mr. Brendsel.

Given this impressive performance, and if it were not for the requirement of the Budget Reconcilliation Act to do so, this Member may not have seen any need for legislative action.

Unfortunately for the GSEs, another old adage, that of "being in the wrong place at the wrong time" is applicable.

It cannot be denied that the newly revived interest and debate over the fu u e of the GSEs comes as a di ect esult of the S&L debacle, the problem of FHA solvency the recent decline in our commercial banks and the just completed adoption of banking reform legislation.

The large losses to the American taxpayer by way of the S&L and banking industries the size of the GSEs and their ever growing importance to the mortgage market and the implicit guarantee that the Federal government would not allow either corporation to suffer extensive losses equire that we examine the safety and soundness of these organizations, the isk to which the Federal government has been exposed by the act v ties of these entities and the changes that may be necessary to meet the public expectation that the taxpayer will not incur yet another financial burden.

I strongly believe as I did when we developed the FIRREA bill, and as we did in passing banking reform, that capital adequacy and strengthened regulation are absolute musts.

At the same time, however in our zeal to provide additional comfort levels, we must not adopt legislation which could seriously impact the overall housing mission of both FANNIE and FREDDIE - the maintainance of stability and liquidity in the secondary market for residential mortgages.

This will not be an easy task as we saw Tuesday when the stock of FANNIE and FREDDIE dropped upon introduction of the legislation. It would appear that the market may not want any change in the way the GSEs are regulated or the levels of capital they hold.

Despite the reaction of the market, I believe the legislation before us gets us moving toward those goals.

I want to commend you and your staff, particularly, Mr. Frank DeStafano and Ms Dana Fisher, for their willingness to work in a close, bi-partisan fashion with the minority staff.

This cooperative effort, which also included close cooperation with Treasury, HUD and the GSEs themselves, should indicate the extreme importance of this matter and that this issue is beyond a partisan, us-versus-them issue.

With respect to the specifics of the bill before us, the legislation is not perfect. But neither were the alternative proposals brought to our attention.

The Treasury proposal, which looked more like an attempt to impose banking regulation and capital levels on the GSEs was parhaps to unrealistic. HUD's proposed regulations for the GSEs were inadequate. The proposals put forward by the GSEs themselves were, in part, self-serving. In other words, we had more than enough suggestions which we then had to compromise on.

Even I was skeptical at the beginning of this process. I, for one, believed it was reasonable to explore the separation of the functional regulation of the GSEs from the safety and soundness regulation as we did in FIRREA.

I was concerned about the Treasury recommendation for an "arms length" organization within HUD which would oversee the safety and soundness issues and why I felt an independent regulator, modeled along the lines of the FDIC, might be preferable.

However, I am confortable that the status of the new regulator we have created within HUD and the ndependence we have given that Office will allow for the proper interaction of opions which will permit the GSEs to continue their housing mission while doing it in a safe and sound manner.

Now, the Secretary of HUD may not like this amount of independence but that is what compromise is all about.

Similarly, I am satisfied that the capital levels and the "stress test" we have included in this bill are adequate to meet a long-term, general economic depression. Although we did meet the concerns of the GSEs on the explicit conditions under which risk-based capital is set, I believe the new Regulator mainta ns the ability to adjust those levels if conditions not now anticipated arise.

Treasury may not like these levels and may argue, on principle, for higher capital but they have not made a case for higher levels nor have they identified what that higher level of capital should be. I do not accept their argument that the Regulator should determine what the capital levels should be. The Congress sets the capital levels for our banks and thrifts and we should do the same for the GSEs.

The GSEs themselves continue to have some problems with the bill. I am sure that they do not like the affordable housing program; the discretion we give the HUD Secretary to review and approve certain new products; or even the salary comparability provisions in the bill.

I may agree with them in a number of ways. Although I will not justify or defend $1 million dollar salaries, maybe pay comparability is not such a critical issue that it belongs in this bill.

They may also have legitimate concerns about the mechanism we have established to carry out the affordable housing program in this bill. But, maybe there really is a small price that must be paid by the GSEs for their "implicit government guarantee".

The special status as government sponsored enterprises enjoyed by FANNIE and FREDDIE allows them to borrow more cheaply in the capital markets than other private corporations; they also are exempt from certain registration requirements and they are exempt from state and local taxes.

While the GSEs do pass most of this government "subsidy" along to home buyers in the form of lower mortgage interest rates, they have been known to be extremely generous to their shareholders and the market has reacted to that.

Nevertheless, there has been concern expressed that housing opportunities are not reaching a certain segment of the general population and that the GSEs must provide more assistance to those potential homeowners. If a better mousetrap can be offered for an affordable housing program, I am sure the Chairman will give it every consideration.

In conclusion, Mr. Chairman I want to again thank you for your cooperation in putting together this bill and I look forward to the testimony and the suggestions for ways to improve this legislation as I am sure we will be offered.

Thank you.

FOR RELEASE ON DELIVERY
Expected at 10:00AM
July 18, 1991

STATEMENT OF
THE HONORABLE ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY FOR FINANCE
BEFORE THE
SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT
OF THE
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

Mr. Chairman and Members of the Subcommittee:

It is a pleasure to be here today to present the Administration's position on H.R. 29000, the "Government Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991" (H.R. 2900). As you know, the Administration has also submitted legislation that addresses the need for enhanced Federal supervision and increased capital of Government-sponsored Enterprises (GSEs).

I commend this subcommittee and the full House Banking Committee for its attention to this issue which is important to taxpayers. The last decade has provided harsh lessons on the need for effective control of risk-taking by financial institutions that benefit from an explicit or implicit Federal Government guarantee The difficulties brought on by the insolvency of a large part of the thrift industry, the 1987 bailout of the Farm Credit System, and the recent difficulties of the Bank Insurance Fund have all focused the attention of Congress and the Administration on other areas of taxpayer exposure to financial risk. GSEs, because of their size and the marketplace perception of an implicit Federal guarantee are financial institutions whose safety and soundness must be of prime concern to public policymakers. The long-term financial viability of the three largest GSEs, Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System, is a special responsibility of this subcommittee. The outstanding obligations of these housing GSEs represent approximately 90 percent of the total outstanding financial obligations of all of the GSEs.

As we reported to the full House Banking Committee earlier this year, based on the analysis conducted for Treasury by the Standard & Poor's Corporation, we have concluded that none of the housing GSEs poses an imminent financial threat to the taxpayer. Unfortunately, the lack of an immediate GSE problem has caused some to suggest "if it ain't broken, don't fix it." We, however,

NB-1376

believe that complacency would be inappropriate. The financially devastating failure of many federally insured thrift institutions in the 1980s was preceded by many years of profitability of these institutions. Similarly, the weakness of many insured banks comes as an unpleasant surprise after years of apparent profits. The luxury of waiting until a financial crisis is painfully evident has now clearly been seen as costly and difficult for the American taxpayer. This subcommittee recognizes that the most prudent policy goal is to establish an effective regulatory framework that will significantly reduce the possibility of another financially painful government rescue.

All of the various GSE studies conducted over the last two years point to the need for more effective supervision of GSEs and a strong cushion of shareholder capital to avoid unforeseen risk to the taxpayer. These considerations provided the basis for the Administration's legislative proposal and should, as well, for this subcommittee's legislation.

The Administration has several concerns about H.R. 2900. These concerns include the lack of primacy for safety and soundness regulation, weaker prompt corrective action and general enforcement powers, the inclusion of an affordable housing program and, most importantly, the proposed capital standards. Because appropriate capital standards are at the heart of responsible GSE legislation, I will use the remainder of my statement to discuss our specific concerns about the proposed capital standards.

Capital Standards

The ability of the regulator to establish and enforce appropriate capital standards for Fannie Mae and Freddie Mac is the single most important regulatory tool needed to ensure their financial safety and soundness The capital standards proposed in H.R. 2900 are a serious concern for two principal reasons First, the proposed capital levels are significantly weaker than those in the Administration's bill. Second, the regulator does not have statutory discretion in determining appropriate capital standards.

The minimum capital standard, or leverage ratio, in H.R. 2900 is lower than that in the Administration's proposal, even though, as of June 30, 1991, Fannie Mae already clears the Administration's hurdle by $100 million, and Freddie Mac, short by $241 million, is expected to meet this requirement from retained earnings within one year.

However, the most glaring weakness is the risk-based capital standard that represents the highest level of capital deemed appropriate for Fannie Mae and Freddie Mac. The risk-based capital level in H.R 2900 is actually lower, by $23 million according to Freddie Mac's own analysis, than the minimum capital level in the Administration proposal. (See attached table.)

H.R. 2900 also eliminates most of the Director's discretion in establishing adequate capital standards, by "hardwiring" in statute the critical assumptions to be used in the stress test. This causes two problems. First, it limits the Director to using stress test methodology, which is very sensitive to changes in parameters, rather than a range of tests based on different methodologies and other market-sensitive indicators. For example, Freddie Mac's own analysis indicates that a change of only 5 percentage points in two critical assumptions, the loss rates upon default and fixed-rate loan prepayment rates, can result in a swing in equity capital requirements of $1.2 billion, or almost one half of its current equity.

Second, the Director would also have no flexibility in choosing parameters because the worst-case scenario would be already dictated in statute. The Director could not then alter the scenario until after a more stressful housing environment has been experienced and identified which may well be too late. If this bill had become law in 1980, the worst-case scenario used would have been 1973, but this would have been replaced two years later by events, the 1981-1984 Texas experience that quickly became the newest worst-case scenario.

What needs to be done in this case is what we and the House Banking Committee have done in banking regulation -- give the regulator flexibility, both with regard to methodology and the choice of scenario and resulting parameters. The Director must have flexibility to adopt new methods of analysis which reflect evolving markets and financial instruments and require that Fannie Mae and Freddie Mac be able to survive in a variety of severe, but still plausible, economic environments.

Why would there be opposition to the regulatory flexibility in the Administration's bill and which has traditionally been given to financial regulators? Fannie Mae and Freddie Mac say that the regulator will set the capital standards too high, thereby denying homebuyers mortgages at reasonable costs. We disagree, and I believe the facts support our case. First, demands for such higher capital should rightfully come from the shareholders not the homeowners. The shareholders of Fannie Mae, for example, have benefitted from a corporate return on equity exceeding 25 percent on average for the last four years (1987-1990), which has translated into a return for its shareholders in excess of 80 percent per year for the last three years to date (representing higher stock prices and dividends). It would surely be possible to retain or raise significant funds to increase capital without causing shareholders to suffer significant distress. In fact, Fannie Mae and Freddie Mac's own internal estimates of their earnings and capital levels over the next three years indicate they will have no difficulty in meeting, through retained earnings, the Administration's critical

capital level, minimum leverage ratio, and any reasonable risk-based capital level. Further, based on their track record and earnings performance, these two GSEs could easily raise additional capital through equity offerings. GAO corroborates this general view when it writes in its most recent GSE study, "We believe it is possible for Fannie Mae and Freddie Mac to meet increased capital requirements without any resulting increase in mortgage rates." These are powerful arguments against dilution of the Administration's proposed capital standards. We do not have to choose between the taxpayer and the homeowner; we can do both -- protect the taxpayer while offering the homeowner mortgage money at fair rates.

If the GSEs have undue concern that the Director will be too zealous in carrying out the prescribed duties by setting the risk-based capital standard too high, each GSE can avail itself of the safe harbor that the Administration built into its proposal. This safe harbor would allow the GSE to be deemed to meet the minimum risk-based capital standard.

Conclusion

In conclusion, let us learn at least one lesson from spending $200 billion on the savings and loan debacle -- that meaningful capital standards, when the taxpayer could be at risk, must be maintained. GSE capital standards must be sufficient to make those enterprises safe to avoid potential risk to the taxpayer. Anything less would be a failure in our responsibility to the taxpayer. The Administration will not support the imposition of capital standards which appear to have teeth but in fact do not provide sufficient protection.

Mr. Chairman the housing agencies are the largest and most visible of the GSEs. The legislation drafted to deal with these agencies will set the standards for the other GSEs. Because these GSEs have established such credible records in the investor marketplace, we have the opportunity to demand that they build strong enough balance sheets to protect taxpayers and at the same time deliver their services at rates which make mortgages available at reasonable cost to homeowners. We do not have to choose between protecting the taxpayer and protecting the homeowner, and we should not.

That concludes my statement. I would be happy to answer any questions the subcommittee might have.

oOo

Freddie Mac's Internal Estimation of House Bill's Risk-based Capital Requirements
Includes Total Requirement for Credit, Interest Rate, and M&O risks (Year-end 1990)

Major Assumptions	A	B	C	Base Case	D	E	F
Loss rates upon default*:	25%	30%	30%	30%	30%	35%	35%
Prepayment rates on fixed rates:	30%	25%	30%	35%	35%	35%	35%
Prepayments on ARMs:	20%	20%	15%	20%	25%	20%	20%

Additional Assumptions
National losses equal worst 3-yr regional experience (set in statute)
All losses occur over 8-yr. period (set in statute)
50% reduction in interest rates (set in statute)
20% additional capital for M&O risk (set in statute)
No new business
Dividends equal to 20% of income
Mortgage insurance disappears in years 7 and 8

Output of Freddie Mac's Model ($ mil.)	A	B	C	Base Case	D	E	F
Primary capital surplus/deficit	358	301	(182)	(279)	(1069)	(916)	(1496)
Equity (core) capital surplus/deficit	(262)	(319)	(802)	(899)	(1689)	(1536)	(2116)

Memo:

House Bill's Statutory GAAP Leverage Ratio		
Equity capital surplus/deficit ($ mil.) (1.5% of on-balance sheet assets, 0.5% of UPB of MBS)	(54)	(19) 2nd Qtr. 1991
Administration's Statutory GAAP Leverage Ratio		
Equity capital surplus/deficit ($ mil.) (2.50% of on-balance sheet assets, 0.45% of face value of MBS)	(302)	(241) 2nd Qtr. 1991

Note: Year-end 1990 primary capital totaled $2,756 million: $2,136 million in equity and $620 million in reserves.
2nd Qtr. 1991 primary capital totaled $3,005 million: $2,333 million in equity and $672 million in reserves.

* This parameter will be fixed in the statute; however, the regulator may have some flexibility in setting this number due to a lack of complete cost data for mortgages originated in the early 1980s.

(From Mr. Glauber)

Response to Question from Congressman Leach (re statistics)

Question:

Is the Treasury prepared to tell us what kind of additional losses too generous treatment of these institutions [Fannie Mae and Freddie Mac] may have for the taxpayer because of the Federal safety net to whom they compete [thrifts and banks]?

Answer:

The effect of the housing GSEs on the financial health of thrifts and banks is unclear. The secondary mortgage markets probably have reduced the yield on conforming mortgages. An often quoted study by Hendershott and Schilling estimates that Fannie Mae and Freddie Mac have lowered conforming mortgage yields by about 30 basis points. Since thrifts and banks are major holders of whole mortgage loans or mortgage-backed securities, this lowers their return on assets, thereby reducing their profitability.

On the other hand, however, the housing GSEs provide substantial benefits to thrifts and banks: (1) secondary mortgage markets provide institutions with access to capital markets to satisfy increased demand for mortgage credit; (2) sales to the secondary mortgage markets lower thrift and bank capital requirements -- Fannie Mae and Freddie Mac MBS receive a 20 percent risk-weight compared to 50 percent for whole mortgage loans; (3) the GSEs help thrifts and banks to manage risk, particularly credit risk, by helping to geographically diversify their mortgage holdings; and (4) the secondary mortgage market increases the liquidity of bank and thrift assets.

With offsetting costs and benefits that are largely unquantifiable, the impact of the housing GSEs on the profitability and future viability of thrifts and banks, and therefore the potential costs of Federal aid to troubled thrifts and banks, is unclear.

STATEMENT OF JOHN C. WEICHER
ASSISTANT SECRETARY FOR POLICY DEVELOPMENT AND RESEARCH
U. S. DEPARTMENT OF HOUSING AND
URBAN DEVELOPMENT
BEFORE
THE SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT
OF THE COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
JULY 18, 1991

Mr. Chairman and Members of the Subcommittee, I am pleased to be here to discuss with you today the Administration's proposal to reform the regulatory structure of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. I will also comment on some features of the legislation that you introduced on Tuesday, Mr. Chairman.

The Administration's Legislative Proposal

On May 28, 1991, the Administration submitted to the Congress a legislative proposal for further regulatory reform of Fannie Mae and Freddie Mac. HUD believes that this proposal would significantly strengthen and improve our regulatory authority to oversee Fannie Mae and Freddie Mac. The Government-Sponsored Enterprises Safety and Soundness Act of 1991 would establish an "arms-length" office within HUD as a safety and soundness regulator for Fannie Mae and Freddie Mac. The new office would be called the Office of Government-Sponsored Enterprise Financial Oversight. The Director of the Office will be appointed by the President with the advice and consent of the Senate. We believe that this proposal is clearly preferable to the approach taken by GAO, which would create a "super-regulator"

for all of the GSEs. The essence of the Administration's proposal is that it provides for the primacy of safety and soundness regulation of the GSEs, while taking advantage of HUD's expertise in housing and providing for the necessary coordination of program and financial regulation.

The Director would be authorized to establish required capital levels with regulatory powers that become increasingly stringent as the capital maintained by the enterprises falls below the required minimum levels. In addition, the Director would be authorized to require reports, to conduct examinations, to issue cease and desist orders, to remove and suspend directors and executive officers, and to impose civil money penalties. These new regulatory and enforcement powers will give HUD the authority needed to ensure the financial safety and soundness of the GSEs. We believe that they are important and necessary.

Mr. Chairman, some analysts have questioned whether HUD can be an effective, independent regulator. We believe that HUD has sufficient stature as a cabinet level department, with broad housing responsibilities, to avoid capture by the GSEs it regulates. HUD's achievements over the last two years demonstrate that HUD is a vigorous, independent regulator within the powers given to it under current law.

The Administration's proposal contains other provisions that will improve HUD's regulatory ability. The Administration has requested that HUD be granted the authority to assess Fannie Mae and Freddie Mac for the full costs of their regulation. However, both enterprises opposed including this authority in the FY 1992 HUD appropriations bill, as proposed in the President's FY 1992

Budget. Because both enterprises are profitable, the Department believes that it is fair that they bear the full costs of regulation made necessary by the special benefits they receive from the Federal Government and by the risks to the taxpayer posed by their activities. The regulators of other financial institutions and other GSEs have similar authority.

HUD has been planning for annual examinations of Fannie Mae and Freddie Mac. This new effort will add significantly to the costs HUD incurs for its regulatory responsibilities. HUD will cover the initial cost of these examinations from its research funds. On a long term basis, however, HUD believes these legitimate regulatory costs should be charged to Fannie Mae and Freddie Mac directly. The Department believes that the authority to charge the agencies for the full costs of their regulation is appropriate and overdue.

Capital Adequacy

Without question, capital adequacy is the most important issue in effective regulation of GSEs, including Fannie Mae and Freddie Mac. Both Charter Acts give the Secretary of HUD general regulatory authority which certainly extends to the safety and soundness of these enterprises. In HUD's proposed regulations, the Department calls upon this general regulatory authority to construct a more effective framework for monitoring capital adequacy and imposing capital requirements on Fannie Mae and Freddie Mac.

A major focus of HUD's regulatory activities during the past year has been the development of financial models for assessing

the safety and soundness of Fannie Mae and Freddie Mac. This model development has involved a major revision and updating in HUD's cash flow model for Fannie Mae and an extension of it to Freddie Mac, and it has also required a new methodology to project prepayments and foreclosures, and detailed information on mortgage experience from the agencies. We believe this approach provides HUD with a very useful tool for regulatory analysis, a model that can project the inflows and outflows of cash that result from any assumed economic scenario.

The Administration's bill would further improve HUD's ability to ensure adequate capitalization. It specifies three capital levels and associated sanctions that would be imposed if the agencies' capital falls short of tha specified levels. The two lower levels are calculated by ratios based on the levels of portfolio assets and mortgage backed securities outstanding, reflecting the differences in risks in these two kinds of businesses. The highest capital level, which must be attained to avoid all sanctions, is determined by the regulator, based on all the risks borne by the agencies, as measured by stress tests and through other analyses. The Administration's proposal would permit a regulatory "safe harbor" for Fannie Mae and Freddie Mac with respect to this highest capital level. If, after receiving credit ratings from two nationally recognized statistical rating agencies, the director were to determine thet a GSE merits the highest investment grade rating, the GSE would be deemed to satisfy the highest requlatory capital requirement for the next year.

Stress tests provide a particularly good mechanism for assessing capital adequacy for credit risks and interest rate risks because they recognize differences in risks between different lines of business, different ways of doing business, and different economic conditions. Stress tests are a technique developed by Moody's to determine the soundness of mortgage insurance firms. They are particularly useful in assessing Fannie Mae and Freddie Mac because these institutions take on many of the same risks as private mortgage insurers. The essence of the stress test is to determine how a particularly bad economic scenario would affect the soundness of a firm. Moody's uses the experience of housing prices and other variables during the Depression for its stress tests. HUD's analysis is similar in many respects to the Moody's model. Unlike more rigid approaches, such as fixed capital standards, stress tests recognize that different ways of doing business will pose different risks to the agencies.

Mr. Chairman, one thing is clear: the current regulatory approach is not sufficient. A capital standard must differentiate between the risks associated with portfolio operations and the risks associated with securitization. Both Charter Acts tie capital to debt, a practice which totally ignores the risks associated with the large and growing securitization business conducted by both Fannie Mae and Freddie Mac. Both Charter Acts include subordinated debt as part of the capital required to be held against debt. This ignores the fact that the capital markets tend to look at Fannie Mae's

and Freddie Mac's agency status rather than their financial status when pricing subordinated debt.

The Subcommittee's Legislation

We are glad to see that the legislation which you introduced on Tuesday, Mr. Chairman, has many features in common with the Administration's proposal.

(1) HUD would continue to be the regulator of Fannie Mae and Freddie Mac.

(2) HUD's regulatory authorities would be strengthened. HUD would acquire significant new enforcement powers, including the authority to issue cease and desist orders, appoint conservators, require capital restoration plans, restrict dividends, restrict growth and assess money penalties for failures to report and comply.

(3) HUD would acquire the authority to charge Fannie Mae and Freddie Mac for the cost of the regulatory office. This should be extended to cover all of HUD's GSE regulatory costs to enable HUD to operate on the same basis as other GSE and financial regulators.

(4) A seperate office would be set up within the Department with sole responsibility for safety and soundness regulation of FNMA and FHLMC.

However, in the fundamentally important matter of capital adequacy, we believe that the bill is inadequate. It retains the Administration's three-level structure for capital standards, but it rigidly codifiea the conditions of stress test methodology in the statute. In addition, it weakens the standards to tha point

of ineffectiveness. Both the minimum and the critical capital levels are substantially lower than the Administration proposed. The minimum capital level standard for on-balance-sheet assets -- including the mortgage portfolio -- is reduced from 2.5 percent to 1.5 percent. The net effect is that the minimum capital level is reduced by 10 percent for Freddie Mac and by 25 percent for Fannie Mae, compared to the Administration's bill. The bill would not require any increase in capital to meet the minimum capital levels. Fannie Mae's current capital would be about the same as the required capital level, while Fannie Mae's current capital would be 25% above the required level.

The standards set in the bill would be a step in the wrong direction. Mortgages held in portfolio are mech riskier than mortgage-backed securities; they are subject to interest-rate risk as wall as credit risk. Nearly every independent analyst who hes studied the GSEs agrees that they are thinly capitalized, and that a higher level of capital is desirable. Both Fannie Mae and Freddie Mac are in the process of increasing their capital.

The bill provides specific tests to apply to FNMA and FHLMC for credit risk and for interest rate risk to determine risk-based capital. However, wa question whether the particular tests specified in the bill are relevant, comprehensive and adequately address the possibility of severe economic shocks to the GSEs. The lesson of recent history is that surprising changes in the economic environment do occur. In 1970 no one was forecasting that the prime interest rate would exceed 20%; no one imagined that the price of crude oil would exceed $40 a barrel. The purpose of capital requirements for FNMA and FHLMC should be to

provide a cushion to protect against severe economic conditions which are not expected to happen. The Moody's stress scenario which is applied to private mortgage insurance firms is designed with this in mind. The Moody's depression scenario involves a 40% decline in house prices, unemployment reaching 25% and a 50% decline in mortgaga interest rates. Companies are required to survive 10 years to obtain the highest credit rating.

There are several problems presented by the stress tests called for in the bill. The stress test under the bill would require capital to protect against default rates on a national scale at the same severity as in the region with the highest default rate for a period of three years. The experience in this "standard" region would be assumed to be maintained for 8 years. There are two ways to interpret the language concerning "worst mortgage loss experience" in the bill: the three origination years with the highest default experiance over the term of the mortgage, or the three years during which the highest percent of mortgagas defaulted, regardless of when the mortgages were originated.

To run a stress test, it would be necessary to make other significant assumptions, including the rato of growth or decline in business, the behavior of interest rates other than the long term Treasary rate and interest rato spreads, and the offects of recourse agreements. The bill also requirms separate analyses of credit and interest risks. Stress tects are generally used to analyso the simultaneous offects of several assumptions that comprise a consistent economic scenario. These more likely scenarios would lead to different effects on the

enterprises than what seems to be contemplated under the bill.

We would be happy to analyze the effects of any fully specified standard that the committee is interested in, and report the capital levels that would be required to meet it. But we believe the design of stress tests should be left to discretion of the regulator.

There are other concerns in addition to the stress test methodology. The bill would require interest risk capital to cover for increases or decreases of the lesser of a 50% change in interest rates or 500 basis points. In the past 20 years, the mortgage interest rate has varied from 7% to over 17%, yet this test would limit the stress conditions to cover an increase from today's rate to only about 14%.

To cover management and operations risk, the bill would allow 20% of the amount required for credit risk and interest rate risk. The damage that can be done by management mistakes, such as incorrectly playing the yield curve, or breakdowns in operations, are surely greater in potential severity than 20% of risks measured by changing economic assumptions, as illustrated by the differing fortunes of different firms in the same field that are often observed. The parameter to relate capital to cover management and operations risks to capital required for credit and interest rate risks should probably be higher than 20%; the exact amount should ba left to the discretion of the regulator.

The stress parameters established in the bill are too limited to describe the extreme economic conditions and the kinds of shocks that the government should be protected against. A

sharp drop in home prices, as in the Moody's depression scenario, a change in the spreads between agency yields and Treasury securities and a sharp change in the slope of the yield curve are the kinds of shocks that should be tested in stress analysis. Moreover, because economic circumstances can change, it is preferable to allow the regulator to establish appropriate stress tests, rather than to prescribe specific stress parameters in legislation.

Conclusion

Mr. Chairman, in the last few years, new public policy concerns have arisen over the safety and soundness of the GSEs. Congress has required five special reports during the past two years from Treasury, CBO and GAO. While these reports agree that Fannie Mae and Freddie Mac do not pose an imminent threat of loss to the Federal government, they also agree that these GSEs are thinly capitalized and that current capital requirements are not adequate to reflect the risks borne by FNMA and FHLMC. In addition, the reports agree that stronger regulatory authority is needed to oversee the agencies. Stronger authority includes greater ability by the regulator to set capital standards, clearer regulatory authorities governing program approval, stronger enforcement powers, and the ability of the regulator to charge for the costs of regulation. The reports differ with respect to the appropriate regulatory structure, but they agree on the fundamentals of appropriate regulation. The Administration's proposal provides the resources and the authority for effective regulation of Fannie Mae and Freddie Mac.

Mr. Chairman, this completes my testimony. I will be glad to answer any questions you or any of the members of the Subcommittee might have.

(MR. WEICHER'S RESPONSES TO CHAIRMAN GONZALEZ' QUESTIONS)

With regard to HUD's discretion in setting the parameters of the stress tests, we believe that:

(1) The 50 percent limit on changes in interest rates would prevent HUD from requiring a capital cushion sufficient to protect against the kinds of interest rate changes that actually occurred as recently as 1975 to 1981.

(2) The language in H.R. 2900 sets specific assumptions for interest rate and credit risks and the stress test. We would prefer that the precise assumptions be determined by the regulator.

(3) Use of a "depression-like" scenario or Moody's assumptions would be preferable to the specific language in H.R. 2900.

(4) With regard to the statutory language regarding the amount of capital for operations and management risk, an earlier version of Section 201(c)(2) of H.R. 2900 stated that 20 percent of the amount of regulatory capital determined by applying the risk-based capital test would be added to provide for operations and management risks. (The bill reported out by the House Banking Committee raised this percentage to 30 percent.) HUD would suggest that the regulator be instructed to determine appropriate additional capital requirements to cover operations and management risks, thus we propose as substitute language:

"(2) MANAGEMENT AND OPERATIONS RISK.--To provide for management and operations risk, an amount to be determined by the Director."

Testimony of

Leland C. Brendsel

Chairman and Chief Executive Officer
Federal Home Loan Mortgage Corporation

Before the

Subcommittee on Housing and Community Development

Committee on Banking, Finance and Urban Affairs

United States House of Representatives

July 18, 1991

45-066 0 - 91 - 9

INTRODUCTION

Thank you for the opportunity to discuss the "Government Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991" that was introduced earlier this week. I would like to commend Chairman Gonzalez, Ranking Minority Member Wylie, and Congresswoman Roukema (Ranking Minority Member of the Subcommittee on Housing and Community Development) for introducing a bill that recognizes the unique characteristics and risks of government-sponsored enterprises and proposes a regulatory structure designed specifically for us.

The proposal recognizes that Freddie Mac is not a bank or thrift -- we have a different mission, take different risks and need a different regulatory structure. I am glad that you have made this distinction clear in light of your simultaneous focus on the banking bill. I urge you to remember this distinction and not allow others to muddy the GSE waters as a result of compromises on the banking bill.

The Subcommittee has taken a giant step forward in the regulation of GSEs. In particular, the Subcommittee has tied the capital requirements to risks and made them stringent enough that the likelihood of a taxpayer bailout is extremely remote. You are leaders in understanding that realistic, risk-based stress tests and market-value accounting -- not simplistic ratios -- are the way to provide real protection to the U.S. taxpayers.

After careful review of the proposal, I have a number of comments -- some major substantive comments and some technical comments. I shall discuss only my major comments today and shall work with your staff on technical comments.

I have concerns in seven areas: capital requirements, regulatory discretion, appropriate remedies, micromanagement, examination process, balancing mission with safety and soundness, and the fundamental change in our structure suggested by the affordable housing program provisions.

CAPITAL REQUIREMENTS

Interest-Rate and Credit Risk

The proposal mandates a stress test that is a stringent, but a realistic test combining worst-case assumptions about interest-rate and credit risk. This stress test must be applied at least quarterly. It requires Freddie Mac to have sufficient capital to survive for eight years while experiencing credit losses on our entire portfolio equal to those of the nation's worst regional experience since World War II. That is currently Texas in the 1980s. However, the stress test would automatically become more stringent if a region experiences a more severe downturn. Five years from now the stress test could be based on the experience of New England in the 1990s.

The stress test is quite severe. It assumes 27 percent of our high loan-to-value mortgages default. While there is a fair chance that some regions of the country will face the economic climate of Texas in the 1980s, the probability that the entire country will face such a downturn is quite low. Applying this experience to all of Freddie Mac's loans is therefore quite conservative.

On top of conservative assumptions about credit losses, the stress test imposes large interest-rate shocks. The stress test requires us to have sufficient capital to survive interest rates that increase or decrease (whichever is worse for the company) by up to 500 basis points and remain at that level until the end of the stress test.

The likelihood that these simultaneous stresses will actually occur is remote at best. As a result, Freddie Mac will be required to hold capital at a level that the Subcommittee can be assured will never result in a taxpayer bailout.

If applied to a thrift or bank holding a mortgage portfolio, this stress test would result in a capital requirement double what these institutions are required to hold by law.

I support the stress test approach. In fact, Freddie Mac has applied this method internally since 1987 to evaluate our capital needs.

My positive comments on the stress test must be tempered by one serious concern. There is a technical problem with the language of the proposal that causes ambiguity in the calculation of our capital requirement. The goal of clarifying the capital standards would be frustrated if this ambiguity is not resolved. This can be done by making clear that the credit risk and interest-rate risk stresses should be measured on a combined basis. We have been discussing this problem with staff and look forward to its favorable resolution.

Management and Operations Risk

The proposal also requires an additional amount of capital equal to 20 percent of the requirement for interest-rate and credit risk to be held to cover management and operations risk. While I believe that it is appropriate to include an add-on for management and operations risk, 20 percent is excessive. Given the stringency of the stress test, the findings by Standard and Poor's Corporation (S&P) and Price Waterhouse about the high quality of our operations, and the natural limit on risk that our charter imposes, I believe that a 10 percent add-on is more than adequate.

As an example, under a 10 percent rule, we would have to hold about $300 million in capital for management and operations risk. Freddie Mac is limited to the purchase of residential mortgages. It is a business we have been in for over twenty years -- and it is a business with well understood risks. While certainly there will be costs associated with risks we misjudge, these costs will not be on the order of $300 million in one quarter, even under a worst-case scenario. Our recent multifamily experience does not even remotely approach losses of this magnitude.

Even worse than the unrealistic amount of the add-on for management and operations risk, the regulator would have the authority to increase it without any justification.

REGULATORY DISCRETION

Management and Operations Risk

While the stress test is stringent, it gives me great comfort because of its specificity. When Freddie Mac sets prices to purchase 30-year mortgages, it is imperative that we know how the regulator will determine the capital requirement for these mortgages over the next 30 years. This proposal goes a long way toward answering that question.

Our primary concern with the Treasury proposal for regulating the GSEs was that the rules of the game were left completely up to the regulator. That not only makes it difficult for us to operate, but also makes it difficult for you to exercise your oversight role.

Unfortunately, much of the good that is done in your proposal by using specific stress tests to set capital requirements for credit and interest-rate risk may be undone by giving the Director of the Office of Secondary Market Examination and Oversight wide latitude to change the capital requirement for management and operations risk. The proposal specifies a 20 percent add-on but it gives the director unbridled discretion to raise that percentage and, in effect, raise our capital requirement overnight without justification. This is unacceptable.

I understand that there may be some reluctance on the part of some to take discretion away from the regulator. After all, 12,000 banks live with regulatory discretion. With only two housing-related GSEs, however, the regulations can be tailored to address their specific risks.

Regulatory discretion certainly did not prevent problems in the thrift and banking industries. It may, in fact, have contributed to lax standards. On the other hand, discretionary regulation can also lead to excessive capital standards. The credit crunch in some markets has been attributed to overzealous regulators.

Further, the top banks in the country, the 12 with at least A+ ratings on their subordinated debt, do not have much to worry about from regulatory discretion -- there are 11,988 weaker banks that would have to be closed first before a regulator would go after the better capitalized institutions. Neither of the two GSEs has this protection.

New Products

Thirty-year, fixed-rate mortgages may suit the needs of many middle-class households. However, very different types of mortgages may be needed to open the door to homeownership to other segments of our increasingly diverse population. By creating a market for new mortgage instruments, Freddie Mac meets homebuyers' and renters' needs nationwide.

Over the years Freddie Mac has not been subject to burdensome prior approval requirements by any regulatory agency before offering new products. This has allowed us to take advantage of market opportunities on an extremely efficient basis. As a result, Freddie Mac has a noteworthy record of innovation in housing finance.

The proposal, unfortunately, incorporates a very complicated and cumbersome system of bureaucratic involvement in new products. The Secretary of the Department of Housing and Urban Development (HUD) must approve every new program, and the Director must set capital requirements for new products.

I believe strongly that we must be able to introduce new programs and products without prior regulatory approval, unless we are not adequately capitalized. As long as we are adequately capitalized, there is no justification for imposing the costs -- to Freddie Mac and to homebuyers -- of a prior approval requirement.

No public policy purpose is served by a prior approval requirement for a well capitalized institution. All mortgage programs that Freddie Mac introduces will foster our housing mission.

As far as safety and soundness are concerned, Freddie Mac sets the capitalization levels for new products by comparing them to our existing products having comparable risk. Freddie Mac should be required to notify the Director of these products and levels.

APPROPRIATE REMEDIES

The proposal allows the Director to downgrade Freddie Mac two enforcement levels under certain circumstances. We think that this much discretionary downgrading is inappropriate. While in limited circumstances it may be appropriate to override the capital requirements, downgrading should be limited to one enforcement level.

Any downgrading should be related to the risk of rapid capital depletion. By contrast, basing a downgrading on a decrease in real estate values is inappropriate because such risks are already captured in the stress test. As a result, I recommend eliminating from the proposal a decrease in property values as a basis for downgrading our enforcement level.

Another concern I have is that the proposed level at which certain enforcement remedies can occur borrow too heavily from the Treasury proposal. For example, as of year end we would have failed the minimum capital requirement. (We currently meet the requirement.)

The remedy for failing the minimum capital standard is conservatorship at the discretion of the Director. It is patently absurd for an A+ rated company to be turned over to the equivalent of the RTC at the option of the regulator.

The use of a conservatorship, if it is ever appropriate for a GSE, should only be considered for a GSE failing its critical capital requirement. The proposal allows the Director to be too quick on the trigger.

MICROMANAGEMENT

I fully support enforcement remedies that allow regulatory intervention early enough to prevent losses to taxpayers. However, if the GSE has adequate capital, regulatory actions should be nonintrusive and should not interfere with the day-to-day operations of the company.

My concern is that the proposal mandates intrusion into the business affairs of Freddie Mac even when we meet every single capital requirement. In particular, the proposal overrides the ability of our Board of Directors to set compensation policy -- one of the most fundamental roles of a Board of Directors. This alone could undermine the success of Freddie Mac.

Top notch directors would be discouraged from serving on our Board because they could not control such an essential policy, and top quality management could leave. There is no substitute for good management. Tying Freddie Mac's hands in this area could prove to be very expensive in the long run. If we meet all our capital requirements, compensation policy is properly set by the shareholders and the Board of Directors.

EXAMINATION PROCESS

Good regulations require good people to enforce them. The proposal prohibits the Director from using contractors to conduct examinations. I am concerned that this will unnecessarily restrict the Director from using the most competent personnel for its oversight of GSEs. Freddie Mac is a sophisticated financial institution. I believe the Director should be encouraged, not prohibited, from drawing on the resources of experienced, professional examiners, such as the Federal Reserve Bank of New York's staff.

I also strongly believe that private rating agencies have an important role to play in ensuring safety and soundness of GSEs. They have experience evaluating the credit quality of financial institutions. Trillions of dollars in securities are priced in the capital markets each day based on rating agencies' evaluations of private companies. I believe it is in the taxpayers' interest to apply their expertise to GSEs. I do not, however, suggest that ratings replace the Director's judgment -- only complement it.

Freddie Mac is willing to be assessed for our fair share of the costs of regulatory enforcement. However, I do not want to sign a blank check. There should be a mechanism for capping our assessments at a reasonable level.

BALANCING MISSION WITH SAFETY AND SOUNDNESS

I am troubled that the balancing process between mission and safety and soundness is unclear in the proposal. More clarification is necessary to avoid conflict and indecision on precisely how these trade-offs are to be made. The proposal does not provide a means for resolving these conflicts, or state whether mission fulfillment or safety and soundness concerns are to be paramount. One way to avoid these conflicts is to give the Director responsibility for both mission and safety and soundness regulation.

FUNDAMENTAL MISSION OF FREDDIE MAC

Freddie Mac's 20-year history provides a proud record of assisting many Americans in their pursuit of affordable housing. The availability of a stable source of mortgage capital in all markets through a wide range of products has significantly enhanced homeownership and rental opportunities in this country. Our long-standing commitment to this mission results in a mortgage market that works today -- when other sectors are experiencing severe credit shortages.

A large share of Freddie Mac's standard loan programs have always served lower-income homeowners and renters. Let me be specific.

- Since inception we have purchased over $500 billion of loans financing 9 million homes.
- We purchased 800,000 loans in 1990 alone.
- We have assisted more than one in eight American families in achieving homeownership.
- We have financed over 750,000 affordable rental units.
- While our loan limit was $187,450 in 1990, the average loan we purchased was about $87,000. (The nationwide average conventional mortgage loan amount was about $100,000.)
- One-third of the loans purchased by Freddie Mac in 1990 had original balances of less than $60,000.
- About 30 percent of the loans Freddie Mac purchased in 1990 were affordable by families earning 80 percent of the median income.
- More than one-half of our multifamily mortgages finance small neighborhood developments with fewer than 50 apartments, which are among the most difficult to finance in the marketplace.

We are very aware that the problem of affordable housing persists for many in this country, particularly low- and moderate-income families. For all the progress and success, we remain confronted by the formidable challenge to provide affordable, quality shelter for all Americans. Freddie Mac's commitment to be a partner in helping to alleviate this problem has never wavered.

Over the past 12 months, we have enjoyed considerable success and made significant progress in serving low- and moderate-income households. The following represents key highlights.

- We committed $3 billion through 1992 to low- and moderate-income homeownership and rental programs;
- We committed to purchase $500 million of mortgages originated in partnership with Michigan allowing flexible downpayments and underwriting waivers and providing borrower counseling.

- We committed to purchase $50 million of mortgages to assist low- and moderate-income union members purchasing their first homes.

- We committed to purchase $5 million of mortgages that lower both downpayment and monthly housing costs for low-income residents in Greensboro, North Carolina.

- We committed $100 million to purchase low-income rental housing mortgages.

- We expanded our equity investments in low-income rental housing to a minimum of $50 million in 1991 and 1992.

- We commissioned a study to determine if our underwriting guidelines make it more difficult for low-income and minority households to obtain mortgages, and took immediate actions based on the findings.

The proposal would have far-reaching impact on how Freddie Mac fulfills our mission to serve low-and moderate-income households. Freddie Mac strongly supports the retention of the low- and moderate-income housing mandate currently in our charter. At the same time, however, I am opposed to requirements for any specific program, percentage goals or volume targets.

Let me speak to two specific issues in the affordable housing provisions. I believe these provisions fundamentally change the balance between our public mission and our ability to use private investment capital to further homeownership and rental opportunities.

Rental Housing Program

The first is the requirement that Freddie Mac provide 20 percent of its dividend payments to a rental housing fund.

This is a triple tax on our dividend payments. We pay 34 percent in taxes on the income passed through as dividends, most investors pay 33 percent in taxes on dividend payments they receive, and under this proposal we would pay an additional 20 percent in taxes on those dividends. That is an 87 percent tax rate on our dividend payments!

This triple tax on our dividends will have significant repercussions on our ability to access capital markets and to fulfill our mission.

Freddie Mac relies on funds raised in capital markets to provide financing for American homebuyers. By using private funds to conduct our activities, we can accomplish our housing mission without congressional appropriation or putting taxpayers at risk. Taking away returns that our shareholders expected would impose windfall losses on current shareholders -- those that purchased the stock after Freddie Mac's restructuring under FIRREA. It would also seriously weaken our ability to tap private capital markets in the future.

While current shareholders do not have recourse against this increased tax, future shareholders do because they have the choice of not investing in Freddie Mac. This type of action will lower the value of the stock.

Our investors will reason, and rightly so, that if Congress expropriates 20 percent of our dividends today, the likelihood that it will expropriate more income tomorrow is greatly increased. The precedent will seriously hamper our ability to raise capital.

I cannot stress enough how significant the costs of this type of action are. Equity analysts following our stock base their buy or sell recommendations, in part, on this kind of "political risk." Imposing a major, structural change on our public/private balance increases this risk substantially, increases our costs substantially, and reduces our ability to fulfill our housing mission.

Intrusion Into Pricing Decisions

The second feature of the proposal that would significantly alter our public/private balance is the prohibition on increasing any fees or charges as a result of the dividend set-aside. HUD would be granted authority to review and revise our pricing strategy if the Secretary determines that Freddie Mac has increased fees or charges as a result of the set-aside.

The proposal is attempting to ensure that the costs of the set-aside are borne entirely by shareholders. Whether or not this is appropriate, the only way for a regulator to enforce it is with massive intervention into our day-to-day activities. The Secretary would have to know the intricacies of our pricing and risks to accomplish this. Simply at the implementation level, I believe this is unworkable. For example, we change prices daily -- if not more frequently -- in response to changing market conditions.

In addition, this provision may create conflicts between the Secretary's responsibility to review pricing and the Director's responsibility to assure safety and soundness. The Secretary might disallow a fee increase at the same time the Director was trying to preserve our capital. At the extreme the provision could lead to lower income and an erosion of our capital base.

Finally, and most importantly, I believe this would fundamentally alter the structure of Freddie Mac. Our management, as guided by our public purpose, our charter, and our Board of Directors is in the best position to determine how to allocate any cost increases because of low- and moderate-income housing programs. We will manage this aspect of our decision-making process as all the others: with care, deliberation and a realization of its impact on our mission.

CONCLUSION

I want to close my testimony with a statement on my personal philosophy on affordable housing efforts. This philosophy permeated the development of the $3 billion commitment that was approved by our Board, and is the foundation upon which our efforts are being built. Let me begin by saying that this corporation -- myself, the president, senior management and the staff -- are all committed to playing a significant role in affordable housing, beth in terms of our leadership as well as in the use of our resources. I think our successes in the past year are clear evidence that we are serious about our involvement in affordable housing.

believe congressional oversight of Freddie Mac allows us the flexibility .ecessary to respond to affordable housing needs in an appropriate manner. I ıope that you remove the specific program provisions from the proposal and ely on the mandates set forth in our charter.

. offer you our full cooperation to work together to make housing available ınd affordable to American homebuyers and renters at no cost to taxpayers.

(FROM MR. LELAND C. BRENDSEL)

RESPONSE TO REP. JOSEPH KENNEDY, II
July 18, 1991 Housing Subcommittee Hearing

As you may know, Congressman Kennedy, Freddie Mac was created to increase the supply of money which primary mortgage lenders can make available to home buyers nationwide By linking the capital markets with mortgage markets, Freddie Mac brings the efficiencies and lower costs of the secondary market to the lender and the homebuyer It accomplishes this mandate by purchasing investment quality mortgages from primary lenders packaging the mortgages as securities, and selling the securities to investors. As you can see, this has not involved housing subsidy-type programs. For example, we do not have a regular program to purchase FHA or VA loans.

The passage of FIRREA in 1989 required Freddie Mac to specifically devote a reasonable portion of its mortgage purchases to housing for low- and moderate-income renters, but with reasonable economic return to the corporation In response to FIRREA, Freddie Mac created its Affordable Housing Initiatives AHI department. The AHI department s first task was to develop a framework for the corporation s long-term commitment to financing low-cost, decent shelter through joint partnerships with private, public and government sectors around the country.

The AHI department tailors affordable homeownership and rental housing programs to suit the unique characteristics of each marketplace and Freddie Mac's customers - mortgage lenders. Its programs also must be continuously refined to meet changing market and borrower needs.

The Freddie Mac single and multifamily initiatives which have evolved from this approach include the following:

Single Family

Freddie Mac's single family activities have included housing partnerships such as the recently announced Union Member Mortgage First Time Home Buyers Program, through which Freddie Mac is committed to purchase $50 mil ion in mortgages to AFL-CIO members. Other commitments include the purchase of $5 million in mortgages through the Greensboro Initiative and $500 million through the Michigan Initiative. All of these initiatives are based on the participation of both the public and private sector, including buyer education, down payment subsidies and flexible underwriting, dedicated to first time homebuyers, to make housing more affordable.

Freddie Mac is also designing a Targeted Lender Initiative (TLI), which is based on the premise that local lenders have the best understanding of their local or regional market and respond to their needs to address FIRREA and CRA requirements. Freddie Mac expects to design the program to fit these needs and to purchase mortgages in partnership with local institutions nationwide.

Multifamily

Freddie Mac is implementing a $100 million transaction with the Local Initiatives Managed Assets Corporation (LIMAC), a national non-profit organization and subsidiary of Local Initiatives Support Corporation (LISC), to purchase a $100 million tax credit eligible for low-income rental mortgages. This transaction was completed in June and is a two-year national program. LIMAC will provide special mortgage review and an underwriting service to help Freddie Mac with this activity.

Freddie Mac is also expanding its participation in the purchase of low-income housing tax credits. Maintaining a priority in purchases with funds operated by non-profit organizations such as the Chicago Equity Fund, LISC and Enterprise should help Freddie Mac double its purchases in 1991. The AHI department is also working with Freddie Mac's real estate owned (REO) staff to assure that a percentage of Freddie Mac's New York and Atlanta stock is purchased by non-profits or owners dedicated to low-income occupancy.

As its affordable housing programs develop, Freddie Mac will try to increasingly use the guidelines available through recent legislation to create programs which better combine public and private resources to meet its affordable housing goals. While this does not currently involve programs like HOPE, HOME, etc., Freddie Mac is optimistic that its recently announced comitment to leverage $3 billion in affordable housing over the next three years can include deals involving these programs

/878

TESTIMONY OF
JAMES A. JOHNSON
CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FANNIE MAE
BEFORE THE
SUBCOMMITTEE ON HOUSING
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES
JULY 18, 1991

Thank you, Mr. Chairman. I appreciate the opportunity to appear before you again to discuss the best way to modernize the capital requirements and oversight of Fannie Mae to protect taxpayers while maintaining -- and further enhancing -- Fannie Mae's ability to serve housing. And I most particularly appreciate the opportunity to congratulate you on the introduction of H.R. 2900, your thoughtful and well-crafted proposal, co-sponsored by Mrs. Roukema and Mr. Wylie.

H.R. 2900 is an outstanding contribution in a number of respects. First, it would establish for Fannie Mae and Freddie Mac a risk-based capital standard that is the most modern, progressive, analytically correct standard in any legislative or regulatory capital regime. Second, by specifying the parameters of that standard, the bill takes a stand and makes the absolutely critical policy decision of just how risk and housing should be balanced. Finally, the bill sets in place a regulatory oversight, supervision and enforcement regime that is strong, yet sensible, and for the most part reinforces the genius of Congress's 1968 decision to make Fannie Mae a private company with private market management and

incentives. We are very pleased with many of the key provisions of the proposed legislation.

When I last appeared before you in late May, Treasury had just delivered its draft bill. I described to you at that time my concerns with that bill. I am very pleased that many of the specific issues we raised have been creatively and effectively addressed in H.R. 2900.

In four areas in particular, H.R. 2900 is a vast improvement over the Treasury bill. The first I have already mentioned: instead of the open-ended regulator discretion of the Treasury bill, H.R. 2900 establishes a specific capital standard. Second, the risk-based capital standard in H.R. 2900 is a complete and specific stress test, not simply a list of risks that the company must capitalize for, as in the Treasury bill. The test is dynamic. It will be a leading indicator of potential problems. For example, if interest rates rise in a quarter, the interest rate requirement will be recalculated, and more capital potentially required; the same if rates fall. If the increase in home prices slows down, more capital will be required for credit risk. If the company takes more interest rate risk by, for example, increasing its duration gap, more capital will be required. If riskier loans are purchased, more capital will also be required.

Third, H.R. 2900 provides for appropriate regulatory structure. Professional and competent oversight is essential if both taxpayers and housing are to benefit from the new regime. Unlike the Treasury bill, H.R. 2900 makes this a real possibility by authorizing hiring outside Civil Service limits. Fourth, the supervisory and enforcement powers in H.R. 2900 are specifically geared to the nature, scope, and unique position of Fannie Mae and Freddie Mac and, unlike the Treasury bill, are not simply a cut-and-paste version of Treasury's bank reform proposal.

Within the context of this very favorable reaction, I want to call the attention of the Committee to four areas that cause us concern: (i) section 201(a)(3), which gives the capital regulator open-ended discretion to increase the capital requirement for management and operations risk over and above that already imbedded in the credit and interest rate risk stress tests; (ii) sections 3(6), 121(f), 121(k), and 201(a)(4) which, combined, could have a paralyzing effect on product innovation, even by a well-capitalized company; (iii) section 121(k) which, by targeting a percentage of dividends for the purpose of making contributions to low-income rental housing, could reduce Fannie Mae's effectiveness in multifamily housing as well as undermine investor confidence; and section 121(e), which would destroy the ability of Fannie Mae's Board of Directors to recruit and retain the best managers for one of the largest financial institutions in the world.

We strongly urge the Subcommittee to delete the clause in section 201(a)(3) that would allow the Director to increase or decrease the management and operations risk requirement from the requirement of 20% of interest rate and credit risk capital -- about $800 million currently for Fannie Mae -- stated in the bill. This open-ended discretion undermines the certainty of the credit and interest rate risk stress tests, and is a serious mistake for three reasons: (i) the amount in the bill is more than enough to cover the type of management risks it is possible to capitalize against; (ii) if the risk-based capital level is left open-ended, Fannie Mae will have difficulty managing our business so we can meet both our responsibilities to housing and our capital requirements; and (iii) it allows the regulator to undercut the choices made in the credit and interest rate risk sections.

Our second area of concern arises out of two provisions that would require the prior approval of two parts of HUD with conflicting mandates before Fannie Mae could undertake any new product or program. Moreover, those provisions interact with a third, under which the Secretary would be required to require a portion of Fannie Mae's business to be for low- and moderate-income housing, in a manner that could lead to total paralysis. To maintain Fannie Mae as a strong, innovative, flexible, private-market provider of housing finance for all, these well-intentioned provisions must be modified. They are unnecessary for a properly capitalized company.

Let's take an example from recent months. In March, I announced a new mortgage called the 3/2 Option, which features a lower down payment on the part of the home buyer, coupled with deeper mortgage insurance to protect Fannie Mae from excessive risk. Since March, approximately 8500 families have purchased houses using the 3/2 Option, almost all families that have never had homes before and had previously been unable to afford one. We are proud of that success. We intend to continue to do more. But the prior approval sections of H.R. 2900 would have required the program to be approved by both the Secretary -- no longer concerned about financial risk -- and the Director -- with no concern about the mission. I do not think it is unfair to HUD to suggest that no families would have 3/2 Option mortgages today if multiple approvals had been required.

Section 121(k) of the bill would require that 20% of Fannie Mae's dividend payments be contributed for acquisition, construction and rehabilitation of low-income rental housing. Fannie Mae wholeheartedly supports, in bcth word and deed, the goal of doing more for low-income rental housing. As drafted, however, this provision is a serious mistake and, in our opinion, should be deleted.

We currently serve 1 million families in multifamily housing under our standard and FHA programs; in 1990, we financed over 104,000

rental units. Approximately 80% of the households served have incomes below 80% of the median. In some places -- Baltimore for one -- the average unit is affordable to those with less than 50% of median income. These are the types of programs in which Fannie Mae excels, the types of programs that use our strength to tap the capital markets to help those in greatest need.

We are now focused on expanding our efforts to serve those with the greatest need. By making investments that support low-income housing on terms that could not be accommodated under standard programs or even our special low- and moderate-income programs -- such as "gap" financing, and predevelopment capital -- we will be able to expand our reach to more low-income tenants.

Section 121(k) of the Bill, with the 20% contribution requirement for low-income rental housing, not only would put Fannie Mae into the subsidy rather than the financing business, but by penalizing shareholders would harm our ability to serve the entire housing market. That is not the way to get the best from Fannie Mae or Freddie Mac.

Finally, it is essential that section 121(e) of the Bill be substantially amended. As drafted, that section would limit compensation of Fannie Mae management to that of Freddie Mac management as of July 1, 1991. This provision would totally

undercut the Fannie Mae Board of Directors' ability to attract and retain the best people to run a $400 billion company safely and profitably while accomplishing our housing mission. The Fannie Mae Board of Directors has long followed the principles of comparability of pay with payment for similar functions at similar corporations, pay for performance, and no pay for non-performance.

In May, I was able to bring you quickly up to date on both Fannie Mae's sound financial condition and our impact on housing, for those all across the income spectrum. Since that time:

- o we reported our fourteenth quarter of record earnings;

- o capital reached $5.6 billion, including $650 million of loan loss reserves, meaning that for the first time (and including the loss reserves), we meet the taxpayer protection capital standards we developed with Paul Volcker and announced well over a year ago;

- o we announced our intention to purchase up to $2 billion in FHA-insured reverse annuity mortgages (HECMs), serving 25,000 elderly households, and a $100 million demonstration program in partnership with the Farmers Home Administration to make mortgage credit more

available to low- and moderate-income households in rural areas;

- our standard business reached record volumes. In the first six months of the year, we purchased more than $16 billion of mortgages and securitized an additional $45 billion.

Fannie Mae is working very well for housing and for the American people.

H.R. 2900 is a major contribution to making certain that Fannie Mae continues this record of success. We look forward to working with you, Mr. Chairman, and the rest of the committee, to make it even better.

Thank you for your attention. I would be pleased to respond to any questions.

Response by James Johnson, CEO, Fannie Mae to question regarding specifics on Fannie Mae's low- and moderate-income housing initiatives by Representative Joseph Kennedy during Housing Subcommittee hearing July 18 on GSEs.

Fannie Mae has developed some very specific programs under the $10 billion plan announced in February. Our goal is to produce $10 billion in commitments for low-and moderate-income housing and special needs housing by July of 1993, and turn these commitments into deliveries by the end of 1994.

Fannie Mae's pledge to affordable housing covers a wide spectrum of programs serving diverse housing needs. The products include both single-family and multifamily housing finance, as well as housing preservation. A number of the specific programs developed thus far are described below:

- **FmHA Guaranteed Rural Housing Loan Program**
  This program was introduced in June 1991. Thus far, we have $21 million in commitments serving 10 states. Under the program, the Farmers Home Administration will guarantee 30-year fixed-rate mortgages in rural areas made by approved lenders under its Guaranteed Rural Housing Loan Program. The program will guarantee loans with and without interest assistance to borrowers at or below 100 percent of local median income as defined by HUD. Losses up to 90 percent of the original loan amount will be guaranteed by FmHA. FmHA will guarantee $100 million in loans under this program during the current fiscal year.

- **Home Equity Conversion Mortgage (HECM)**
  We recently expanded our participation in the FHA-insured, Home Equity Conversion Mortgage (HECM) program. As of June 1991, we had $41 million in commitments under this program. FHA will insure 25,000 home equity conversion mortgages. This mortgage program enables older homeowners to convert the equity they have in their homes into cash using a variety of payment options to address their specific financial needs. Unlike a traditional home equity loan, a borrower does not qualify on the basis of income but on the value of his or her home. The loan does not have to be repaid until the homeowner moves, sells or refinances the property, or dies. At that time, the amount to be paid will equal the lesser of the loan balance or the appraised value of the home.

- **Seniors Housing Opportunities (SHO)**
  SHO is an ongoing $100 million demonstration project designed to test several approaches to seniors' housing (Accessory apartments -- apartments included in a single-family home; ECHO housing -- temporary units built on a family member's property; Homesharing -- the sharing of a one-to-four family home by two or more adults; and Sale-leaseback -- the sale of a home to an investor who then rents it back to the seller). The ideas that work in this demonstration will be incorporated into Fannie Mae's standard mortgage products.

- **Magnet (sm) Employer-Assisted Housing**
  In early April 1991, we introduced the Magnet Employer-Assisted Housing products and already have $342 million in commitments as of June 1991. The high cost of housing in some areas has made it difficult for many employees to find affordable housing near their place of employment. Employers in these areas have found that the lack of affordable housing undermines their efforts to attract and retain qualified employees. As a result, we have developed a number of specific products that can be used by employers to help their employees by providing funds for down payments, closing costs, or monthly housing expenses. Magnet provides two basic housing products -- Magnet 5 (sm) and Magnet 3/2 (sm). Magnet 5 is designed to assist employees of any income level. Magnet 3/2 is targeted to low-and moderate-income employees who have difficulty accumulating the minimum down payment and whose income is below 115 percent of area median income as defined by HUD. This product allows borrowers to contribute only 3 percent towards the required down payment, with employers providing the remaining 2 percent in the form of a grant or unsecured loan.

- **Community Lending Programs**
  Fannie Mae, in cooperation with housing providers, offers six community lending mortgage products designed to help low-and moderate-income families purchase homes. These lending models, which include Subsidized Second Mortgages, Community Home Buyer's Program, Community Home Improvement Mortgage Loans, Community Land Trust Mortgage Loans, and HUD Urban Homesteading Demonstration, were developed to meet the widest variety of needs of low-and moderate-income home buyers. As of July, 1991, Fannie Mae had over $2 billion in commitments for these community lending programs.

  In March, 1991, we enhanced the Community Home Buyer's program with a new 3/2 option. Under the CHBP, Fannie will purchase or securitize 15- and 30-year fixed-rate mortgages insured by private mortgage insurers. Loan-to-value ratios may be as high as 95 percent. The 3/2 option allows home buyers to meet the minimum 5 percent down payment requirement with a minimum 3 percent contribution from their personal resources and up to 2 percent in the form of a gift from a family member or grant or unsecured loan from a nonprofit or public entity.

- **Public Finance Programs**
  We are also working directly with state and local housing finance agencies (HFAs) to reduce the cost of mortgages that are financed with mortgage revenue bonds (MRBs) and to help HFAs increase the supply of low-and moderate-income housing in their jurisdictions. By selling MRBs directly to us, HFAs can reduce their borrowing costs and make mortgage financing available to first-time home buyers at lower costs than would otherwise be possible.

As part of our $10 billion affordable housing initiative, our goal is to purchase $1.5 billion in new MRBs by the end of 1992. In the first six months of 1991, we purchased $231 million in MRBs.

o **Tax Credit Equity Investments**
In response to a growing shortage of rental housing, Fannie Mae invests equity in low-income rental housing that qualifies under the federal tax credit program, originally authorized by Congress in 1986. Since the program's inception, we have committed to invest over $170 million, representing over 9000 affordable units in 22 states and the District of Columbia. This makes Fannie Mae the largest single corporate investor to date. We have pledged to increase our investments by more than $150 million over the next two years. These investments include responses to some of the toughest problems in housing: permanent housing for the formerly homeless, affordable housing for single men and women working for minimum wages, adequate housing to replace substandard housing in rural areas, and housing for large families.

During the hearing, Representative Kennedy also asked for our comments on programs that will require private financing over the course of the next several years (e.g., FIRREA-mandated housing, expiring use, HOPE, HOME, Federal Home Loan Bank Board mandated housing and others). Some of our efforts in these areas include:

o **Fannie Mae Affordables**
In direct response to the FIRREA legislation, we developed an MBS product for members of the Federal Home Loan Banks (FHLBs) in coordination with the 12 FHLBs. The program, called Fannie Mae Affordable, allows members of the FHLBs to pool special below-market rate home loans originated for low-and moderate-income families. Fannie Mae Affordables are pools of 15- and 30-year fixed-rate mortgages funded with Federal Home Loan Bank advances or direct subsidies issued under the two FIRREA mandated programs -- the Affordable Housing program (AHP) and the Community Investment Program (CIP). As of June, 1991, Fannie Mae had commitments for about $20 million in loans to lower income home buyers and we are working with lenders on another $40 million in these loans using this program.

o **Preservation of "expiring use" housing**
Fannie Mae holds the mortgages on a large percentage of federally assisted "expiring use" projects at risk of prepayment and conversion to market rate housing. We hope to play a major role in helping to preserve this housing as affordable. Fannie Mae will participate in financing preservation transactions through the purchase of section 241 second mortgages, on the purchase of the bonds which back section 241 loans. We will also expand our support of nonprofit groups to help them assume ownership of threatened projects.

- **RTC Affordable Housing Program**
Fannie Mae has actively worked with the RTC in leveraging their funds for affordable housing. We are working with the RTC in financing single-family properties under their Affordable Housing Disposition Program. We have purchased a total of $123 million in mortgage revenue bonds from the Florida Housing Finance Agency, Louisiana Housing Finance Agency, Mississippi Home Corporation, Oklahoma Housing Finance Agency, and Texas Housing Agency to finance approximately 2,800 properties in RTC's affordable housing inventory. Secondly, we created a new method for financing RTC-owned condominiums that will allow previously investor-owned units to be sold to low- and moderate-income owner/occupants. We negotiated the first sales for about 25 units in a 108-unit condominium in Maryland with several hundred more units in the pipeline in Arizona. The RTC is providing a second mortgage for these transactions equal to 20 percent of the sales price.

  On the multifamily side, our Southwestern Regional Office is conducting a pilot study to evaluate the feasibility of our purchasing first mortgage loans originated by our lenders to finance properties sold under RTC's Multifamily Affordable Housing Disposition Program.

- **Other Program Initiatives**
Fannie Mae plans to work with HUD and state and local governments implementing the programs of the National Affordable Housing Act of 1990, in particular, HOPE and HOME. This includes both single-family and multifamily components that may be linked to the programs described earlier, especially those in the community lending area.

APPENDIX

July 19, 1991

OPENING STATEMENT

CHAIRMAN HENRY B. GONZALEZ

JULY 19, 1991

Today the Subcommittee reconvenes to consider the testimony of additional witnesses on H. R. 2900. I welcome these witnesses here today.

STATEMENT OF

DANIEL F. EVANS, JR.
CHAIRMAN
FEDERAL HOUSING FINANCE BOARD

TO THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

JULY 11, 1991

Introduction

On behalf of the Federal Housing Finance Board (Finance Board), I am pleased to submit this statement on the Federal Home Loan Bank (FHLBank) System and the recent studies on Government-Sponsored Enterprises (GSEs). Our statement focuses on the role of the FHLBank System, its safety and soundness, the steps the Finance Board is taking to ensure the FHLBank System's continued strength and our vision of its future as a partner for housing and housing lenders.

From our perspective, this hearing is about two issues: (1) the risk to the Government from the operations of GSEs; and (2) housing policy and the GSEs' role in fulfilling that policy. The Finance Board's message to the Committee is also twofold. First, and most importantly, the FHLBank System is safe, sound, well capitalized and conservatively managed. It is truly, as Standard and Poor's Corporation has found, a AAA investment for the Federal Government.

Secondly, while the FHLBank System is safe, it is undergoing its own post-FIRREA transition and is being artificially constrained in its ability to serve the housing goals shared by this Committee and the Finance Board. The System's traditional thrift membership base is declining as the RTC merges, consolidates and liquidates insolvent institutions, much of whose deposit base is being purchased by commercial banks. While FIRREA appropriately opened up the FHLBank System for commercial bank membership, it created unnecessary restrictions to their joining the System. This has adversely impacted the FHLBank System's public purpose, since commercial banks now originate over 40 percent of all mortgages. At the same time, the current structure is unfair to the System's existing thrift members, which are mandatory, since commercial banks are free to withdraw from the System at will. These membership rules should be equalized.

Also, from a housing policy standpoint, the disparity between the capital structures of the three housing GSEs is undermining the FHLBank System's ability to serve portfolio lenders. As stated by the Congressional Budget Office (CBO) in its report:

> "Setting comparable federal capital requirements for these three GSEs would eliminate the disparity in the implicit federal support that each provides to the lenders they serve. It would increase the profitability of thrifts and other lenders that use FHLB advances and would be a step toward enabling them to compete on an equal footing with Fannie Mae

> and Freddie Mac in the market for financing conventional mortgages." (Controlling the Risks of Government-Sponsored Enterprises, CBO, April 1991, p. 67)

These are important questions that need to be addressed in a comprehensive approach to GSE issues. Timely action will enhance the System's ability to retain its AAA standing, as well as continue its contributions to the thrift resolution process, while fulfilling its important role in our Nation's housing policy.

The FHLBank System Poses Virtually No Risk to the Government

The recent GSE reports accurately portray the strong capital, high credit quality, conservative management and low-risk profile of the FHLBanks. Based on these findings, the reports come to the same conclusion about the safety and soundness of the FHLBank System: it poses virtually no risk to the Government.

The safety and soundness of the FHLBank System is best summarized by three facts, each of which was noted in the GSE reports: (1) Standard & Poor's has provided the FHLBank System with a AAA rating exclusive of its agency status, several levels higher than any other housing GSE; (2) the FHLBank System has never suffered a credit loss on its advances in

its 60 years of operation; and (3) the FHLBank System has a capital-to-asset ratio of seven percent. These achievements reflect the combination of the high credit quality and low interest rate risk of the FHLBanks.

The FHLBank System's collateral lending practices are also an important contributor to its excellent credit standing. Unlike mortgage guarantors, such as Fannie Mae and Freddie Mac, if the value of the FHLBanks' mortgage collateral declines, or the health of the borrower deteriorates, the FHLBanks can require additional collateral. This greatly reduces the risk to the System and therefore to the taxpayers. Furthermore, as pointed out in the GSE studies, the System's assets and liability are well-matched.

The Finance Board agrees with the safety and soundness conclusions in the GSE reports. In fact, as pointed out by the CBO, the FHLBank System may actually be overcapitalized in relation to its low-risk profile. The System's seven percent capital ratio dwarfs those of other GSEs. It also may be limiting the System's ability to serve housing finance.

The Finance Board Is A Strong And Independent Regulator

The GSE reports also reflect the seriousness with which the Finance Board has undertaken its safety and soundness mission. We believe the Finance Board is providing the type of strong oversight that Congress envisioned in FIRREA. Our actions include the types of recommendations in the new GSE reports: onsite examination, offsite monitoring and comprehensive regulatory policies. Together, these actions provide a higher level of comfort to the Federal Government than previous practices. Moreover, our authorities are similar to those proposed in the reports for GSE regulators generally. Thus, we believe that, in many ways, the Finance Board can serve as a model for much of what Congress seeks to accomplish in this area.

A. Onsite Examination

The Finance Board has commenced annual onsite examinations of the FHLBanks, something that had not been done for several decades. These examinations address each FHLBank's internal controls, management, operational issues (e.g., collateral adequacy and valuation), and other FHLBank activities to ensure full compliance with all statutory, regulatory, and policy requirements.

These examinations are in addition to the internal and external audit activities of the FHLBanks. Each FHLBank has an internal audit staff that reports directly to the Audit Committee of its local Board of Directors. The Finance Board receives copies of all internal audit staff reports and the quality of each staff's performance is reviewed as part of our examination process.

Each year, the Finance Board also contracts for an external audit of the FHLBanks. This audit is performed by an independent accounting firm.

B. Offsite Monitoring

Onsite examination is only part of the overall monitoring conducted by the Finance Board. The Finance Board receives monthly balance sheets, income statements, and cash flow statements from each FHLBank. Unlike many financial regulators, the Finance Board's reports are usually available within two weeks after the end of a month. The Finance Board also maintains detailed information on the FHLBanks' investments and monitors the financial condition of FHLBank members. In addition, the Finance Board approves annual budgets and receives quarterly budget reports analyzing

differences between each FHLBank's budget and actual income and expenses. These latter reports assist the Finance Board in evaluating the efficiency with which the FHLBanks carry out their housing finance mission.

C. Comprehensive Regulatory Policies

The Finance Board is well on its way to a comprehensive revision of policies associated with the financial safety and soundness of the FHLBanks. Our goal is to ensure that the policies we establish for the FHLBank System limit risks and recognize and anticipate changes in the financial markets.

For example, while previous investment policies were already quite restrictive, the Finance Board recently revised these policies to broaden their coverage to include all on- and off-balance sheet activities, as recommended by the GSE reports. This revised Financial Management Policy limits FHLBank investments to high quality, short-term Treasury, agency, and money-market instruments. Investments in mortgage-backed securities are limited to "AAA" and agency securities, and are limited also as to amount. To the extent that this investment authority is an expansion of previous policy, there is a two year sunset date on that expansion. Moreover, for the first time, the Financial Management Policy

limits the amount of unsecured credit that the FHLBanks may extend to any given counterparty. The amount of credit is linked to the counterparty's credit rating and capital level. The policy also establishes, again for the first time, absolute limits on the amount of interest rate risk the FHLBanks may undertake. These limits all but guarantee that the FHLBanks will not be harmed by unexpected movements in interest rates.

The Finance Board is also reviewing the capital and dividend policies for the FHLBanks to ensure that these policies facilitate the accomplishment of the FHLBank housing mission in a safe and sound manner.

Regarding regulatory authority, we recognize that the Finance Board has broader authority than that of some other regulators. This authority was provided to the Finance Board in recognition of the joint and several liability of the twelve FHLBanks. That liability requires strong and coordinated oversight of the FHLBanks to ensure that possible weaknesses in one FHLBank do not impact the health of the other FHLBanks or the System. It also allows the Finance Board to ensure that the FHLBanks carry out their statutory housing mission in a safe, sound and efficient manner.

Regarding regulatory structure, we have questions as to the benefits to be gained by the new superregulator that the General Accounting Office (GAO) recommends creating. We believe that the current regulatory structure works well and provides valuable Systemwide direction beyond that which is possible at tha individual FHLBank level. We believe that continued stability for the System is important at this time.

<u>The FHLBanks' Role in Housing Finance</u>

Housing finance has evolved significantly over the last 20 years, particularly with the development of active secondary markets in some mortgage instruments. These markets have led to an increased role for Fannie Mae and Freddie Mac, the two GSEs that focus on secondary market activities.

The FHLBanks also play an important role in housing finance, although different from either Fannie Mae or Freddie Mac. The FHLBanks facilitate housing finance by financing the origination and holding of mortgage loans and mortgage securities at depository institutions. Fannie Mae and Freddie Mac facilitate housing finance by purchasing and pooling conforming mortgages, then guaranteeing securities backed by the mortgage pools. Both roles are important for housing.

A. Mortgage Funding

Through their advance programs, the FHLBanks provide member institutions with cash to originate and fund mortgage loans. Member institutions that borrow from the FHLBanks directly benefit from the FHLBanks' AAA credit rating. The FHLBanks' strong capital base and conservative risk profile enable FHLBanks to access the capital markets on favorable terms--often as little as 10 to 15 basis points above Treasury securities of comparable maturity--and to pass on this funding advantage to their member institutions. This directly benefits many of the nation's homebuyers since the FHLBanks' funding advantage translates to readily available and competitive mortgage financing.

By providing a funding mechanism for all types of residential mortgage loans held in portfolio, FHLBank advances support various types of mortgage assets that are not readily securitized, including a variety of adjustable rate mortgages and many multifamily mortgages. The flexibility provided by FHLBank advances thereby facilitates housing finance for sectors that often do not lend themselves to the standardization requirements of the secondary market, including mortgage loans for low- and moderate-income housing.

B. Liquidity

The FHLBank System advances also serve as an important source of liquidity to member institutions. Mere access to the System, even if rarely used, reduces the amount of relatively low-yielding liquid assets a member would otherwise need to hold. This enhances member profitability. It also permits member institutions' excess funds to be channeled into housing, furthering the public purpose of the System. Furthermore, by serving as a liquidity source for member institutions, the FHLBanks help maintain the integrity of the deposit insurance funds.

C. Asset/Liability Management

In addition to their funding and liquidity functions, the FHLBanks offer products that assist their members in asset/liability management. FHLBank advances can be matched to the maturity characteristics of mortgages, offering a simple and straightforward method of asset liability management. This helps members avoid the safety and soundness problems associated with maturity mismatches.

Alternatively, member institutions can enter into hedging arrangements directly with the FHLBanks or obtain a letter of credit from the FHLBanks to support hedging transactions with third parties. With the expected introduction of interest rate risk capital guidelines, access to the FHLBanks will become more important to portfolio lenders.

D. Community Lending Activities

Through the use of the FHLBank System's Affordable Housing Program (AHP) and Community Investment Program (CIP), lenders can combine the System's mortgage financing benefits with programs affordable to low- and moderate-income groups. These programs allow the FHLBank System to facilitate affordable rental housing and home ownership. The CIP funds also can be used for economic development activities that benefit low- and moderate-income neighborhoods.

During 1990, a total of 895 applications were received for the AHP program, requesting a total of nearly $284 million in subsidies. 383 applications were approved for funding. The program funds were highly leveraged. The average unit had a development cost of $47,800 and an AHP subsidy of $3,250, yielding a leverage ratio of 14.7 to 1. Two-thirds of these are rental units. Over half the units are for very low-income households, and one-quarter of the very low-income households served by the AHP program will be able to purchase their homes.

Moreover, the FHLBank System furthers the public policy goals of the Community Reinvestment Act (CRA) by ensuring that mortgage liquidity is always available for community lending, regardless of the characteristics of either the mortgage or the mortgagee. Thus, an institution can meet its community-lending responsibilities even if Fannie Mae and Freddie Mac cannot securitize a particular loan. In addition, these System programs assist member institutions in meeting their CRA requirements.

Creating a Level Playing Field

The FHLBank System has traditionally been the only GSE to provide longer-term financing for mortgages and support for portfolio lenders. However, as noted by the CBO:

> "[T]he FHLB System is more heavily capitalized than are the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), and this discrepancy is one factor that puts the depository institutions served by the FHLB System at a competitive disadvantage in financing conventional mortgages. Making the capital standards comparable for all three GSEs would equalize the implicit federal subsidies provided to them and would be a step toward leveling the playing field in the housing finance system." (emphasis added) (Controlling the Risks of Government-Sponsored Enterprises, CBO, April 1991, p. 199-200.)

Advances from the FHLBanks currently require a member to purchase capital in its FHLBank equal to 5 percent of the amount advanced. Moreover, current regulations require the FHLBanks to maintain capital equal to approximately 8 percent of consolidated obligations--the primary funding sources for advances. Neither Fannie Mae nor Freddie Mac face similar capital requirements. In fact, both Fannie Mae and Freddie Mac operate with capital levels of approximately one percent. By contrast, the FHLBanks have a capital-to-asset ratio of 7 percent. Applying the commercial bank risk-based capital standards, the FHLBanks' risk-adjusted capital ratio exceeds 30 percent.

These higher relative capital requirements limit the FHLBanks' ability to facilitate housing finance through their support of portfolio lenders. If, however, the Finance Board were given authority to establish new FHLBank capital requirements reflective of the AAA credit rating of the FHLBanks, as all GSE reports suggest, and as the Administration has proposed for Fannie Mae and Freddie Mac, housing finance could see substantial benefits.

By establishing capital requirements for the FHLBanks that are more reflective of the FHLBank's low risk profile, the total markup on advances could fall dramatically. For example, each one percentage point of capital requires a FHLBank to markup its advance rates by approximately 7 basis points to maintain an acceptable dividend level. Thus, changing the capital requirements to reflect risk could have significant benefits to housing finance as lower funding costs to lenders can result in lower mortgage rates. Furthermore, permitting the FHLBanks to leverage their substantial capital base could mitigate any adverse effect on housing from Fannie Mae or Freddie Mac being required to raise additional capital. This would serve the dual interest of this Committee in limiting the Federal Government's risk from the GSEs while promoting a sound housing policy.

The FHLBank System, Like Mortgage Finance, is in Transition

Mortgage finance is undergoing an evolution. Whereas the thrift industry historically provided the majority of funding for mortgage origination, it now provides approximately 25 percent of that funding. Commercial banks and mortgage bankers now originate almost 40 percent and 30 percent, respectively, of all mortgages. This phenomenon is partially due to the merger, consolidation and liquidation of hundreds of thrifts by the RTC as a result of FIRREA.

FIRREA also had a serious impact on the FHLBank System. As the Competitive Equality Banking Act (CEBA) had done in 1987, FIRREA, too, required retained earnings from the FHLBank System to be devoted to the resolution of insolvent thrifts. The combined capital loss to the FHLBank System from CEBA and FIRREA was in excess of $3 billion, plus a fixed 40-year obligation to REFCORP of $300 million per year (representing 20 percent of the FHLBank System's 1988 earnings).

FHLBank System assets have declined $70 billion since FIRREA, a trend that will continue with additional thrift resolutions. The System's advances of $95 billion are the lowest since 1983. Nearly one-third of these outstanding advances are to institutions which currently do not meet their capital requirements. Therefore, without changes, the FHLBank System could shrink to as little as $70 billion in advances by 1994.

With the decline in traditional thrift membership advances due to thrift resolutions, the shrinkage of balance sheets caused by the new capital rules, and the majority of mortgages being originated by non-thrifts, the System's gross earnings have declined from the 1989 record level of $1.8 billion to a 1991 projected income of $1.2 billion. The fixed REFCORP contribution further reduces this figure to $900 million.

While these earnings are large in absolute size, when spread over the FHLBank System's $10.5 billion in capital, FHLBank System's earned dividend approaches eight percent.

Recently, the FHLBank System has experienced success in attracting new commercial bank members. While the fear of further RTC capital diversion from the System may create a disincentive to membership, the economic benefits of joining the System are increasingly being recognized. Current commercial bank membership stands at 250. The pace of adding new members to the System is also increasing. The FHLBank System admitted more commercial bank members in the first four months of 1991 than it did in all of 1990. In fact, the System now has 11 commercial bank members whose assets exceed $1 billion.

While the prospective commercial bank membership base is significantly greater in asset size than the thrift industry, the pace of new members added to the System has not kept pace with the loss in thrift members due to insolvencies. Thus, without changes that serve to encourage System membership, REFCORP contributions will consume an ever-increasing percentage of FHLBank System earnings. These FIRREA obligations currently approximate the maximum 34 percent corporate tax rate. These obligations will likely exceed the corporate tax rate by 1994, causing dividend rates to decline

to as low as six percent. This would increase the desire of members to withdraw, motivate some members to redeem excess stock, and affect the System's ability to attract new commercial banks as members.

In fact, as noted by the CBO in its GSE study, FIRREA contained several impediments to commercial bank membership. For example, FHLBank System stock purchase requirements are significantly higher for commercial banks than thrifts. Thrifts must purchase a minimum level of FHLBank stock equal to one percent of their mortgage assets. Commercial banks, however, due to the makeup of their balance sheet, are often required to purchase a minimum level of stock equal to three-tenths of one percent of their total assets. Despite a potentially equal dollar commitment to housing finance, this requirement can far exceed the one percent of mortgage assets required of thrifts.

For advance users, thrifts are required to purchase stock equal to five percent of their advances. In other words, they can leverage their investments by a ratio of 20:1. The minimum stock level for commercial bank borrowing is five percent divided by their mortgage investment percentage, which can reduce the leverage of commercial bank capital to as little as 2:1. Therefore, for a $100 million advance, a thrift is

required to purchase $5 million of stock while a commercial bank may have to purchase as much as $50 million of stock. As dividends fall, these stock purchase requirements can be onerous.

The disincentive for commercial bank membership is exacerbated by the limitation that total advances to non-QTL lenders may not exceed 30 percent of a FHLBank's outstanding advances. With the fall in FHLBank advances, this is a shrinking cap.

In sum, these provisions serve to restrict the FHLBank System to a group of mortgage lenders that provide less than one-third of total mortgage finance. While housing is the public policy purpose of the FHLBank System, these provisions prevent the FHLBanks from serving much of that market. Moreover, these restrictions are not designed to take into account the actual impact of a given financial institution on housing. For example, a large commercial bank with 20 percent mortgage assets may well represent a greater dollar commitment to housing than some QTL lenders.

The Finance Board believes that all members should be treated equally. We are currently analyzing possible changes to membership requirements that would stabilize the System's

profitability, maintain its attractiveness to new members, and ensure the continued fair treatment of existing members, thereby improving the System's ability to serve housing.

A Healthy FHLBank System Is In Housing's Best Interest

The FHLBank System has been a good partner for housing and housing lenders for 60 years. We believe this partnership should be strengthened and enhanced because of the housing-related benefits that result.

First, FHLBank advances enable members to originate residential mortgages and create assets which do not conform with national underwriting guidelines. The FHLBank System has a solid and growing role in assisting financial institutions in meeting the credit needs of their local communities. Despite the recent changes in the financial services industry, there is still an important role for community lenders. Portfolio lending that does not rely on national standard underwriting criteria can be much more responsive to local housing credit needs and development conditions. The FHLBanks also assist smaller community institutions in developing the technical capacity to do community lending. The Affordable Housing Program already has been successful in this regard, and the Community Investment Program can assist in larger economic development goals.

Second, from a safety and soundness standpoint, the FHLBank System can mitigate against some of the safety and soundness concerns associated with mortgage lenders, such as the interest rate risk resulting from funding long-term mortgages with short-term deposits. The FHLBank System enables housing lenders to match fund their mortgages, thereby alleviating such interest rate risk. This function will become even more important with the adoption of interest rate risk capital guidelines.

Third, many community lenders have expressed concerns about the impact of interstate banking on their deposit base and on their ability to effectively compete with larger regional institutions with direct access to the capital markets. The FHLBank System can help address these concerns. Low-cost FHLBank advances can serve as a competitive replacement for lost retail deposits. Furthermore, the FHLBank System can provide community banks with their own access to the capital markets.

The nation's diverse housing needs require a diversity of lenders as well as a diversity of product. Public policy should facilitate this goal. The capital and leverage profile of Fannie Mae and Freddie Mac place portfolio lenders,

institutions important to the nation's diverse needs, at a significant competitive disadvantage. With some changes, the FHLBank System can help to offset this disadvantage and assist in achieving our housing goals. We look forward to working closely with this Committee on these issues.

1125 Fifteenth Street, N.W.
Washington, D.C. 20005

Mortgage Bankers Association of America

FAX: (202) 452-8785
PHONE: (202) 861-6585

STATEMENT OF

Stephen B. Ashley

Chairman & C.E.O.

Sibley Mortgage Corporation

on behalf of the

MORTGAGE BANKERS ASSOCIATION OF AMERICA

before the

SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT

of the

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

UNITED STATES

HOUSE OF REPRESENTATIVES

Hearings on

HR 2900
The Government-Sponsored Housing Enterprises
Financial Safety and Soundness Act of 1991

July 19, 1991

Mr. Chairman and Members of the Subcommittee, I am Stephen B. Ashley, Chairman and C.E.O. of Sibley Mortgage Corporation, headquartered in Rochester, New York. I am also serving as the 1991-1992 Chairman of the Legislative Committee of the Mortgage Bankers Association of America (MBA).* Accompanying me today are Michael J. Ferrell, MBA's Senior Staff Vice President and Legislative Counsel and Sharon M. Canavan, MBA's Deputy Legislative Counsel.

MBA appreciates the opportunity to appear before you today to testify with respect to the role of the Federal government in stabilizing the mortgage credit markets and ensuring a supply of affordable mortgage credit through the programs and operations of the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal National Mortgage Association (FNMA).

MBA urges a measured response that will establish appropriate capital standards that adjust with dynamic changes as they take place in the market or with the development of new products. We also support appropriate monitoring and oversight by the Department of Housing and Urban Development (HUD), which we believe can be achieved as long as HUD is provided sufficient support to give it the capacity and expertise to perform this job credibly. We believe that HUD has the "will" so long as it is given the resources to have the "way." The imposition of excessive safety and soundness goals without factoring in the mission of FNMA and FHLMC will have a significant impact on both mortgage credit *affordability* and *availability*.

MBA supports Federal sponsorship of a mortgage credit delivery system. We believe this support should be provided through secondary mortgage market programs and operations that are self-sustaining and actuarially sound. By all accounts the mortgage securities and purchase operations of FHLMC and FNMA cover their administrative expenses and have established reserves. Their operations are all subject to varying degrees of regulatory oversight and control. Their missions, finally, are specifically circumscribed in their Congressionally mandated charters.

MBA strongly supports the current status of FHLMC and FNMA, as privately owned, federally chartered corporations, supporting the secondary mortgage market and assuring an ample supply of housing credit at a reasonable cost.

MBA supports adequate capitalization for FHLMC and FNMA as well as appropriate regulation of their continued safety and soundness. These requirements must be rational and attainable in order to allow these corporations to fulfill their mission of providing adequate and affordable supplies of single-family and multifamily mortgage credit for low-, moderate-, and middle-income home buyers and renters.

---

* The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of residential and commercial real estate finance. MBA's membership comprises mortgage originators and servicers, as well as investors, and a wide variety of mortgage industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, selling, and servicing real estate investment portfolios. Members of MBA include:

- Mortgage Banking Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Mortgage Insurance Companies
- Life Insurance Companies
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; Telephone: (202) 861-6500.

MBA believes that capital and regulatory requirements should promote safety and soundness goals, but should also be sensitive to the housing mission, which is the basis for Congress' creation of FHLMC and FNMA. Such requirements should also be clearly related to specific risks associated with the different types of mortgages, investment securities, and guarantees provided by FHLMC and FNMA.

MBA believes that excessive capital requirements--beyond levels reasonably related to the risks borne by FHLMC and FNMA--will increase mortgage interest rates. Rational capital levels directly related to projected risk under stress scenarios, combined with effective regulatory controls and monitoring, will enhance safety and soundness without unnecessarily impacting mortgage credit availability and affordability.

In attaining mandated capital requirements, FHLMC and FNMA should strive to preserve mortgage credit affordability. Fees and charges to seller/servicers should bear a direct relationship to the risk of the type of mortgages purchased or guarantees provided.

MBA supports HUD as the regulator of FHLMC and FNMA for compliance with the mission and mandates of their Congressional charters, as well as for safety and soundness. HUD understands the housing support and mortgage credit role that these corporations fulfill. HUD should be given the financial management support necessary to monitor and evaluate FHLMC and FNMA and to enforce requirements necessary to ensure that FHLMC and FNMA maintain their financial soundness and their ability to play a meaningful role in providing housing and mortgage credit.

MBA supports regulatory reviews and enforcement powers to ensure safety and soundness to protect taxpayers from the potential of any Federal expenditures on behalf of these corporations. The business operations of FHLMC and FNMA should be monitored and subject to examination, audit, and enforcement actions. However, this regulatory control should be sensitive to the necessity of these corporations to operate flexibly in fast-paced financial markets. The ability to make innovations and create new mortgage programs to meet ever changing consumer needs should not be stifled.

Background.

Approximately 63 percent of the loans originated by mortgage bankers are purchased or securitized by FNMA and FHLMC. Consequently, MBA has a sound knowledge of the secondary mortgage market and the factors that have been largely responsible for the success of the secondary market enterprises over the years.

Furthermore, MBA believes the strength of these secondary mortgage market enterprises has been pivotal in avoiding mortgage credit shortages since the passage of the Financial Institutions Reform, Recovery and Enhancement Act of 1989 (FIRREA). Thrifts and commercial banks have been able to maintain their mortgage operations and investments by dealing with FNMA and FHLMC, whose mortgage backed securities carry a preferential risk-based capital weighting over portfolio holdings. Home borrowers have not experienced the credit crunch that has so seriously affected other types of real estate-related mortgage finance. Since the passage of FIRREA, the share of mortgage credit supplied by FNMA and FHLMC through their securities and purchase activities has grown from 33 percent in 1989 to 42 percent in 1990.

FNMA and FHLMC are national secondary market institutions dedicated to providing affordable housing for homeowners as well as renters. Enhancements they bring to the housing marketplace include:

- Strong credit ratings that ensure the lowest possible interest rates (as much as one-third to one-half percent lower than if these enterprises were not in the market).

- Total dedication to housing that ensures continuity throughout credit cycles and, over the long-term, in the flow of credit to housing.

- Integrity and experience that further contribute to their standard-setting roles in the national mortgage market.

- Economies of scale that help ensure the lowest possible costs, and the benefits of creative new programs, which are passed along in the form of affordable and decent housing.

Both FHLMC and FNMA have a clear Congressional mandate to provide mortgage credit for affordable housing. FIRREA enhanced and clarified the mission of FHLMC and FNMA by incorporating in the Statement of Purpose section of their charters the following:

> "to provide ongoing assistance to the secondary market for home mortgages (including mortgages securing housing for low-and moderate-income families involving a reasonable economic return to the corporation) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for home mortgage financing."

Mr. Chairman and Members of the Subcommittee, the stark reality of our ongoing budget deficits has put tremendous pressure on the government's ability to dedicate adequate resources to housing and has resulted in the reining in of programs to enhance mortgage credit opportunities for Americans. FHLMC and FNMA have stepped in where the government has left off. Both corporations have increased their commitment to affordable housing in recent years and have done so in a responsible and prudent manner that has not put the taxpayers at undue risk.

The role of FHLMC and FNMA will be even more important in the years to come. The statutory changes to FHA that were enacted last year in the Cranston-Gonzalez National Affordable Housing Act will, in MBA's opinion, seriously erode the role that FHA has historically served, which was to ensure a stable supply of low downpayment mortgage insurance for low- moderate- and middle-income borrowers, particularly first time home buyers. We believe that recent statutory changes taken in tandem with HUD's aggressive regulatory interpretations will weaken FHA's effectiveness as a tool to help deliver affordable mortgage credit. We hope that FHLMC and FNMA will be able to enhance their role in ensuring stable supplies of affordable, low downpayment mortgage credit and that the private mortgage insurance industry will provide the necessary backstop to FNMA and FHLMC's purchase and securities programs.

Likewise, in the area of multifamily mortgage credit, HUD's active role has been significantly diminished. FNMA and FHLMC with their sophistication and market presence can and should ensure that a market exists for soundly underwritten multifamily projects as well.

In addition to fulfilling a housing mission, FNMA and FHLMC must conduct their operations prudently. We believe that the better the oversight, the less capital is needed. FNMA and FHLMC live with oversight. They are scrutinized by Congress, regulated by HUD, overseen by the Treasury Department, audited by the General Accounting Office and public accountants, regularly examined by Wall Street investment analysts, and are accountable to common stockholders.

All of the Congressionally mandated studies have been released. While recommendations for capital levels and regulatory structure vary, the reports did conclude that FHLMC and FNMA are financially sound, well managed corporations and pose no immediate risk to taxpayers. However, the studies did recommend that supervision needed to be tightened.

Presently, several statutes and regulations provide for continuous monitoring of FNMA and FHLMC by the Treasury Department, HUD, and the GAO. Treasury has the authority to approve the form of securities issued by these agencies. Its primary function has been to determine the timing as to when FNMA, and now FHLMC, should be in the marketplace with debt obligations, because of the impact their market presence could have with respect to issuances by other agency borrowers and the Treasury.

HUD, by virtue of the Charter Acts of FNMA and FHLMC, is empowered to exercise general regulatory oversight and rulemaking authority, to require appropriate reports, and to pre-approve new issuances of capital stock, dividends relating thereto, and convertible debt. In addition, HUD has the express authority to increase or decrease the maximum debt-to-capital ratios of these agencies.

Despite these existing authorities, concerns about potential contingent liability have grown, fueled in large part by the thrift and bank crises. There are a multitude of distinctions between the activities of financial institutions with the direct exposure posed by deposit insurance versus the implicit guarantee theoretically backing the inherently less risky activities of FNMA and FHLMC. Nonetheless, the legislation before us today represents a challenge--to balance the goal of safety and soundness with rational capital requirements and regulatory oversight so as not to topple a workable system that has well served American home buyers and renters.

HR 2900, the "Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991."

Safety and Soundness vs. Program Mission

Regulator for mission and safety/soundness. The bill establishes an independent Office of Secondary Market Examination and Oversight (OSMEO) within HUD. The HUD Secretary retains general regulatory authority over FNMA and FHLMC. Definitions of the parameters for the stress tests used to calculate capital requirements are established in the statute, although OSMEO retains the power to determine compliance and to require the enterprises to rebuild capital in the event of noncompliance.

MBA supports the establishment of an independent office within HUD to monitor the performance of FHLMC and FNMA, their compliance with capital standards, and to take enforcement actions necessary. As stated previously, we believe this office should be provided with the resources to perform these functions capably. MBA is concerned, however, that the duties and powers of HUD vis-a-vis OSMEO should be clearly delineated and should not be duplicative.

The General Accounting Office study, published in May 1991, strongly recommended creation of an independent GSE regulator that would regulate and oversee the activities of all GSEs. MBA believes this proposal should not prevail. HUD has the housing and secondary market expertise needed to regulate FNMA and FHLMC properly, and this expertise is not easily transferable to a generic GSE regulator.

Degree of Control by Regulator

Product and Program Approval. The HUD Secretary must give written, prior approval to any new program and that this approval power will extend even to existing programs.

MBA is strongly opposed to this expansive power, because we believe it will stifle innovation and can be used to further political or philosophical objectives that have nothing to do with safety or soundness considerations. We believe that the Congressionally drafted charter adequately outlines the powers and authorities of FNMA and FHLMC to engage in mortgage-related activities. So long as they are healthy, programs that respond to rapidly changing markets and economic environments are necessary. We believe that the risk-based capital requirements will serve as adequate controls on new products where the potential for risk because of lack of market experience is a concern.

Monitoring performance and compliance. FNMA and FHLMC would be required to submit quarterly reports to OSMEO on their financial condition, and such other reports as requested. GAO's power to audit is expanded from mortgage transactions to financial transactions. *MBA supports* effective, frequent monitoring as the most appropriate method of evaluating the financial condition of these enterprises and ensuring that capital is matched to current conditions. We believe that effective monitoring and supervision should take the place of the provisions requiring prior product approval, which places excess power in the discretion of OSMEO to increase capital for operations and management risk, particularly where an entity meets or exceeds the highest capital standard.

The bill provides for assessments against FHLMC and FNMA to pay for the monitoring and oversight functions performed by OSMEO. *MBA supports* an assessment against FHLMC and FNMA to provide the necessary funds to establish and maintain this office.

Penalties and Sanctions. Civil monetary penalties can be assessed for filing false or misleading reports. The severity of the penalty is based on whether the violation is unintentional or intentional.

Cease and desist orders, as well as civil monetary penalties, can be imposed against FNMA or FHLMC whenever an activity could threaten core capital, or whenever a violation of a law, rule, regulation, written condition, or written agreement has occurred or is about to occur. The Director of OSMEO is empowered after a hearing to issue a wide range of orders to correct the situation, including the power to restrict the growth, dispose of any asset involved, rescind contracts or agreements, and to take any action determined appropriate.

A temporary cease and desist order power pending a hearing can be imposed for any violation or activity that threatens to seriously deplete capital, cause insolvency, or weaken the enterprise prior to the completion of a full blown proceeding.

Although any order can be appealed to a Federal Court of Appeals, any order remains in place until the resolution of the review.

MBA believes that these powers and sanctions are exceedingly broad. While the government must be able to step in to protect its interests, these powers as drafted virtually allow an enterprise to be brought to a complete halt while the government puts together its case. MBA would like to suggest that cease and desist orders be required to be precise so as to target a particular activity or activities that are being questioned. Furthermore, the restrictions against bringing evidence before a court are excessive, particularly because there is not an administrative hearing or review board now in place with a body of standards or a record of proceedings.

Restrictions on Compensation or Dividends. The power to pay dividends is suspended any time when the risk-based capital level is not achieved. Otherwise, the entities are required to report to OSMEO before declaring any dividend payments. *MBA believes* that so long as an entity achieves the highest capital requirement, there should be no reporting requirement. OSMEO, through its oversight and monitoring functions, should be able to ensure safety and soundness without interfering in the corporate management decisions of the Board.

Compensation for employees is to be established by FNMA/FHLMC's Board of Directors at a level "comparable" to other similar businesses, but is capped at the executive salaries being paid to FHLMC executives on July 1, 1991. *MBA opposes* the cap on salaries, but supports language requiring that salaries be "comparable" to other similar businesses. FNMA and FHLMC are large, sophisticated corporations, which must be able to pay competitive salaries in order to attract and retain top flight talented employees.

Capital requirements

Risk-Based Capital Levels. The statute defines credit risk and interest rate risk and requires each enterprise to establish capital reserves equal to the sum of those defined risks. In establishing the risk-based capital levels, OSMEO must take into account appropriate distinctions among types of mortgages and their seasoning--the factors should include: single vs multifamily, fixed vs adjustable rate, lien priority, mortgage term, occupancy (owner vs investor), and whether or not there is negative amortization.

MBA supports the risk-based capital requirements contained in this bill, but *opposes* the undefined discretion of OSMEO to increase the add-on component covering operations and management risk. We believe that the 20 percent add-on requirement *already* anticipates a cushion for risk. At a minimum, standards for the exercise of a discretionary increase should be clearly delineated in the statute.

MBA would also like to note that the factors in judging risk based capital requirements focus exclusively on the mortgage products themselves. There are other factors that should also be weighed in arriving at risk-based capital standards, such as whether mortgages are held in portfolio or guaranteed as securities, whether loans are purchased with or without recourse, etc. Obviously, to some degree these factors are included in the interest rate and credit risk assumptions, but we believe they should be more clearly spelled out.

Credit risk assumes losses on a national scale for an eight year period at the rate and severity occurring within a region during the worst loss experience.

To cover interest rate risk, the enterprises would be required to establish additional capital whenever interest rates shifted, either up or down, in the event that rates moved by the lesser of 50 percent or 500 basis points and remained there for eight years.

An add-on component requires the enterprises to add 20 percent above the amounts required to cover credit and interest rate risk in order to cover management and operations risk (and OSMEO can increase this add-on amount to reflect actual risks.)

OSMEO can also require additional capital for risks associated with any new program.

MBA believes that strong capital requirements are necessary to protect the government from contingent liability. If those capital levels are being achieved, however, we believe quite strongly that interference in day-to-day operations, program and financing decisions, etc. should be left in the hands of the management and boards of the entities.

If there are concerns that new programs cannot be adequately evaluated for risk because of lack of a track record, some additional capital should be required, so long as that add-on capital requirement is required to be correlated to anticipated risk. However, standards for the exercise of that discretion should be clearly defined.

Minimum Capital Levels. The proposal requires minimum capital levels representing marked-to-market equity equal to 2 percent of on-balance sheet assets and 1 percent of off-balance sheet obligations, plus core capital equal to 1.5 percent of on-balance sheet assets and .5 percent of off-balance sheet obligations.

Critical Capital Levels. Whenever capital falls to 50 percent of the minimum capital levels, this would activate the critical capital levels and the accompanying regulatory controls.

MBA supports the requirements in HR 2900 for minimum and critical capital levels.

Rating agency. There is no reference to any rating requirement in the proposal. MBA is pleased to see that the proposal does not include a requirement for private ratings for the enterprises.

Enforcement Levels

The enforcement mechanisms contained in the bill are related to the maintenance of capital at certain levels. OSMEO has the discretion to reclassify the enforcement level of an enterprise by up to two levels (and thus enhance enforcement powers) whenever any action could rapidly deplete capital or the value of secured mortgages is decreasing significantly.

Level I. This enforcement level assumes no extraordinary powers by OSMEO. Regulatory capital would have to meet or exceed the risk-based capital requirements and the minimum capital levels.

Level II. If the enterprise meets the minimum capital level, but does not meet the risk-based standard, then OSMEO must notify Congress; the enterprise must develop a capital restoration plan; and dividend payments are restricted so that they do not cause capital to fall to Levels III or IV.

Level III. If the enterprise does not meet the minimum capital level, but does not fall below the critical capital level, then more stringent supervisory requirements are activated. A capital restoration plan must be developed; the enterprise can pay dividends only with prior approval by OSMEO; and all activities undertaken must be approved by OSMEO. At OSMEO's discretion, other more invasive regulatory actions may be taken, including: limiting or reducing obligations, curtailing asset growth or requiring contraction, prohibiting dividend payments, requiring new capital to be issued, amending any activity that creates excessive risk, limiting executive compensation, and/or appointing a conservator.

Level IV. If the enterprise does not meet the critical capital level or is downgraded under the discretion of OSMEO (see above), then OSMEO must appoint a conservator, who will operate the enterprise in the name of the enterprise.

MBA supports the enforcement mechanism levels contained in HR 2900. They appropriately trigger action to increase capital and to rectify problem situations quickly. *MBA is concerned* that the discretion held by OSMEO to reclassify the enforcement level by up to two steps could be too precipitous. We believe that a one-step reclassification with immediate notification to Congress would be sufficient.

Affordable Housing

HUD may require a "reasonable portion" of the mortgage purchases by the enterprises to be devoted to low- to moderate- income families. *MBA supports* this requirement. In particular, MBA believes that one of the primary housing affordability concerns today is the difficulty that first time home borrowers have in accumulating savings for a downpayment. We would urge that stimulating homeownership for this target group should be a specific goal.

Additionally, the bill mandates an affordable housing program funded by FNMA and FHLMC at a level of 20 percent of their previous year's dividends. *MBA supports* the concept of requiring FHLMC and FNMA to demonstrate a commitment to low-and moderate-income housing, particularly in the multifamily arena.

The lack of available multifamily mortgage credit, particularly for low-income projects, is a serious problem today, particularly for older properties, which tend to be low-income. FHLMC has been out of the multifamily market for over a year, although they are gearing up for a new program. This has had a devastating impact on multifamily mortgage financing. FNMA, while it has remained in the market has fairly stringent underwriting guidelines, which tend to favor newer projects. HUD has only begun to implement its Delegated Processing program and so its activities are confined primarily to full insurance HUD processed loans. The problem is not so much one of lack of equity, but the lack of financing avenues. There are instances today of low-income tax credit projects that are not being closed, because of lack of available financing.

MBA opposes the particular solution delineated in Section 331 for several reasons. First the program would be funded as a tax on homeowners, who are the ultimate source of FNMA/FHLMC revenues. Second, and most importantly, the program would not result in significant levels of funding for multifamily housing. We believe that more units would be produced, even for the needy families targeted by this proposal, with an affirmative requirement to finance a specified number of units.

MBA strongly believes that FNMA and FHLMC must shoulder the burden of enhancing housing opportunities, as well as enjoy the benefit of profitably ensuring stable supplies of mortgage credit. We would welcome the opportunity to work with the Committee in devising methods to ensure a strong commitment by FHLMC and FNMA to affordable multifamily rental housing and to innovative programs for first time homebuyers.

Summary

Although there are concerns with HR 2900, MBA believes that the proposal represents a measured approach that can accommodate the dual objectives of safety and soundness with the public mission to promote housing affordability and mortgage credit availability.

FNMA and FHLMC are government chartered enterprises whose operations are legislatively circumscribed and are subject to both legislative and regulatory review. If FNMA and FHLMC were required to raise an arbitrary amount of capital to help protect the government against extremely remote economic circumstances, this would raise their costs and result in higher interest rates for home borrowers.

MBA believes that these agencies are fiscally sound corporations that provide mortgage credit at the most affordable rates possible, make money for their stockholders, and pay taxes.

MBA supports adequate capitalization for FHLMC and FNMA, as well as appropriate regulation of their continued safety and soundness. However, capital and regulatory requirements should also be sensitive to their housing mission. Such requirements should also be clearly related to specific risks associated with tha different types of mortgages, investment securities, and guarantees provided by FHLMC and FNMA. MBA believes that in light of the types of risks incurred by the agencies and their ongoing strategies for controlling interest rate and credit risk, excessive capital requirements are not necessary and, in fact, would limit credit availability and raise interest rates for homebuyers. Moreover, MBA believes that additional GSE regulation should not be so onerous as to result in, or encourage, higher guarantee fees paid by seller/services and lenders.

We believe that a capital-driven and growth-constrained business will invest only in gold-plated product, which is not the public policy mission Congress conferred by charter. FNMA and FHLMC are unique in that they were chartered as private companies with public missions: to engage in public-private partnerships to finance housing for poorer families through community lending, purchase of mortgage revenue bonds, and equity investments using low-income housing tax credits. This broad service to American families, which has worked well and has earned strong, continuing support from policy makers, housing advocates, and home buyers would be discontinued if safety and soundness concerns were followed without concern for the public mission of FNMA and FHLMC.

MBA appreciates the opportunity to testify before this Subcommittee and will provide answers to questions or requests for additional information, if needed.

MORTGAGE BANKERS ASSOCIATION OF AMERICA

Michael J. Ferrell
Senior Staff Vice President/
Legislative Counsel
Legislative Counsel

Tel. (202) 861-6509
Fax (202) 452-8765

August 7, 1991

Honorable Henry B. Gonzalez
Chairman
Subcommittee on Housing and Community Development
Committee on Banking, Finance, and Urban Affairs
U.S. House of Representatives
2413 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

This information is being furnished for the record of the July 19, 1991 hearing held by the Subcommittee on HR 2900, "the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991."

At the hearing (on page 72 of the record), you asked MBA's witness, Stephen B. Ashley, if the capital requirements for the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation contained in HR 2900, as introduced, would result in higher mortgage rates. MBA supported the capital provisions in HR 2900 and did not believe they would have affected mortgage interest rates.

Our concern was that the Administration's proposed capital requirements were excessive and would impose an unnecessary financial burden on potential homebuyers through higher mortgage rates. The Administration's proposal allowed for a tremendous amount of flexibility on the part of the regulator, to create a method for determining the possible risk exposure of the GSE's activities. This type of flexibility could result in stress test scenarios to be established that have little or no rational or historical basis and would likely result in unnecessary costs to homebuyers. Because the Administration's proposal allowed for so much flexibility in determining risk-based standards, a quantifiable judgement on the exact amount of such an increase would not be possible.

Again, we appreciated the opportunity to appear and would be pleased to furnish any additional needed information.

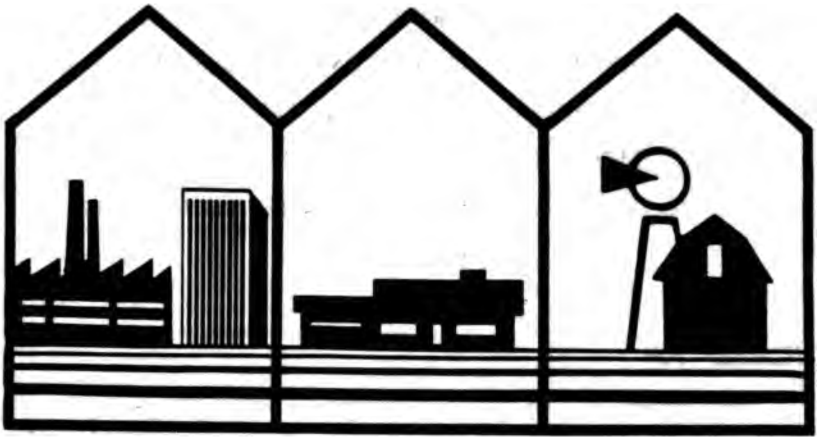
Sincerely,

Michael J. Ferrell

Michael J. Ferrell

MJF:ltj

MBA
1125 Fifteenth Street, N.W. ■ Washington, D.C. 20005-2766



Statement of the

NATIONAL ASSOCIATION OF REALTORS®

The Voice for Real Estate™

THE WORLD'S LARGEST TRADE ASSOCIATION

TO:	U.S. HOUSE SUBCOMMITTEE ON HOUSING, COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
SUBJECT:	FINANCIAL SAFETY AND SOUNDNESS OF GOVERNMENT-SPONSORED ENTERPRISES (GSEs)
BY:	RICK ADAMS, CHAIRMAN OF THE REAL ESTATE FINANCE CONVENTIONAL MORTGAGE COMMITTEE
DATE:	JULY 19, 1991

STATEMENT OF THE

THE NATIONAL ASSOCIATION OF REALTORS®

ON GOVERNMENT-SPONSORED ENTERPRISES

BEFORE THE SUBCOMMITTEE ON HOUSING

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

JULY 19, 1991

INTRODUCTION

Mr. Chairman, members of the Subcommittee, my name is Rick Adams. I am a REALTOR® from San Antonio, Texas, and the Chairman of the Real Estate Finance Conventional Mortgage Committee. On behalf of the approximately 780,000 members of the NATIONAL ASSOCIATION OF REALTORS®, I am pleased to have the opportunity to present this Association's views on legislative proposals designed to enhance the financial safety and soundness and ensure the continued viability of Government-Sponsored Enterprises (GSEs), specifically the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

NAR commends you, Mr. Chairman, for holding these hearings to examine the financial soundness of Fannie Mae and Freddie Mac. NAR believes that it is entirely appropriate for Congress to assert its jurisdiction over the housing related GSEs. We believe it is the role of Congress, and Congress alone, to oversee that these GSEs operate in a safe and sound manner while continuing their publicly charged housing mission.

My testimony today will focus on: (1) an analysis of the role of Fannie Mae and Freddie Mac in the secondary mortgage market and the services they provide; (2) an overview of the various Federally mandated studies on GSEs and the current legislative climate; (3) the Association's position regarding H.R.2900, "The Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991"; and (4) the Association's position on H.R. 2747, "The Government Sponsored Enterprises Financial Safety and Soundness Act of 1991".

I. GSEs ROLE IN THE SECONDARY MORTGAGE MARKET

Impact of Secondary Market GSEs

Fannie Mae and Freddie Mac perform roles that are central to the secondary mortgage market. Since Fannie Mae's reorganization in 1968 and Freddie Mac's establishment in 1970, the secondary mortgage market has evolved through its infancy to its current maturity, sophistication and efficiency. These two entities and the Government National Mortgage Association (Ginnie Mae) (the latter of which securitizes the mortgages insured by the Federal Housing Administration (FHA) and guaranteed by the Department of Veterans Affairs (DVA), are crucial in the home mortgage delivery system. They successfully integrate mortgage markets -- homebuyers -- with the capital market. Based on the activities of these GSEs, the secondary market has grown substantially from its infancy in the late 1970s and early 1980s. Between 1980 and 1989, the annual volume of mortgages repackaged as securities and sold in the secondary market increased from $22 billion to $195 billion. By the end of 1989, there were $750 billion in mortgage-backed securities outstanding, $360 billion of which were Ginnie Maes.

Fannie Mae and Freddie Mac dominate conventional mortgages. The Department of Housing and Urban Development (HUD) estimates the conforming conventional mortgage market share of the total dollar volume is 78.5 percent. Fannie Mae and Freddie Mac's market share is estimated at nearly 86.3 percent. Together they have financed homes for over 17 million American families.

Promoting Stability and Liquidity For the System

These two enterprises sole dedication to mortgage finance, and concomitantly, their dedication to staying in the system at all times lends a stability to the system that would not otherwise be there. For example, in the 1970's and 1980's, interest rates swung wildly and traditional suppliers of mortgage funds were unable to hold deposits against such competitors as money market funds. Mortgage funds were not always available, except those funds provided by Fannie Mae and Freddie Mac; Fannie Mae and Freddie Mac stayed in the market when other companies withdrew. However, from 1982, conventional originations have grown fairly steadily from $78 billion, reaching an estimated $343 billion in 1990, despite savings and loans institutions' declining participation in home lending. Fannie Mae and Freddie Mac are responsible for that growth and stability in the housing market. During the 1980's, studies indicate that Fannie Mae and Freddie Mac brought at least $450 billion of liquidity into the housing markets that otherwise would not have been.

Providing Consistent Nationwide Source of Mortgage Finance

The national scope of Fannie Mae's and Freddie Mac's operations enhance the flow of mortgage funds among all geographic regions of the country. Their focus on home lending allows them to support mortgage lending in all economic circumstances and, more importantly, across all areas of the country. In 1986, for example, when states such as Texas and Oklahoma experienced a severe downturn, Fannie Mae and Freddie Mac remained in the market when private companies withdrew. Similarly, today, in the Northeast, Fannie Mae and Freddie Mac are helping that area of the country avoid a residential "credit crunch" which would parallel the commercial credit crunch. These nationwide sources of mortgage credit will ensure that potential homebuyers in economically depressed states will not be locked out of the market.

Reducing Mortgage Interest Rates

Fannie Mae and Freddie Mac help reduce mortgage interest rates as a results of their federal ties and the way they do business. As the Office of Management and Budget (OMB) recently noted, the federal relationship allows Fannie Mae to borrow significant amounts of money along the yield curve at rates between 25 and 75 basis points below those for the mostly highly rated corporate debt. Likewise, Fannie Mae and Freddie Mac's federal ties lead investors to accept its guaranteed mortgage-backed securities at relatively low yields and result in lower cost to lenders packaging a pool of loans. These phenomena lower the cost of homeownership to consumers by an average of 50 basis points. This savings translates into $2.5 billion in savings to homeowners each year.

Contribution to Market Efficiency

Stated last, but of equal importance, is Fannie Mae and Freddie Mac's contribution to market efficiency. They have brought standardization and homogeneity to mortgage products. They have created an efficient, smoothly functioning and highly disciplined market structure.

II. RESULTS OF FEDERALLY MANDATED STUDIES ON GSEs AND OVERVIEW OF CURRENT LEGISLATIVE CLIMATE

Two years ago, as part of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), Congress mandated a number of studies be conducted on the GSEs. At that time, Congress had just enacted legislation appropriating $50 billion to pay off insured depositors of a crisis-riddled savings and loan industry, with the

knowledge that the cost could eventually grow even higher. Needless to say, at that time, any corporate entity that had any sort of "tie" to and could pose a contingent liability to the Federal Government came under the watchful -- indeed, concerned -- eye of Congress. Congressional members were concerned that the GSEs might pose undue risks to taxpayers as the thrift debacle had done. Congressional concern, as reflected in the subsequently mandated studies, was both necessary and appropriate to ensure that another industry bailout did not occur. In addition, last year both Houses of Congress, in the Omnibus Reconciliation Act of 1990, passed resolutions calling for the consideration of legislation to regulate GSEs by September 15, 1991.

We must, however, remind the members of this Subcommittee that we are not at the same place in time we were in August, 1989. We now have the benefit of seven studies from five different agencies who have all concluded that Fannie Mae and Freddie Mac are generally well-run, well-managed and well-capitalized. For example:

o The Congressional Budget Office found that Fannie Mae and Freddie Mac have "been consistently and highly profitable in recent years" and "large changes in interest rates are unlikely to harm Fannie Mae and Freddie Mac significantly";

o The Office of Management and Budget, in this year's President's budget, wrote that Fannie Mae and Freddie Mac entail "close to zero" risk to taxpayers while transmitting a substantial subsidy to homebuyers in the form of lower mortgage rates;

o Federal Reserve Chairman Alan Greenspan, in testimony before the Senate Banking Committee in June, 1990 on the "credit crunch" issue, said, "The continued flow of credit in residential mortgage markets owes much to the many alternatives to despository credit. The securitization of home mortgages has become a routine financial transaction, with about $1 trillion in mortgage debt held in that form. Buyers of these securities have stepped in to acquire assets shed by thrifts and to fund new lending".

In summary, after lengthy and intensive review, all the reports have cited again and again that these two housing GSEs are ideas that work. Fannie Mae and Freddie Mac are now two case studies which Congress can refer to with pride as enterprises that balance public sector goals with private sector initiatives. Given this "housing GSE clean bill of health", we believe Congress should focus on how to protect and preserve Fannie Mae and Freddie Mac's successes while continuing to protect the taxpayer from potential contingent liabilities becoming actual liabilities.

We realize that the thrift debacle and, following in its wake, the current financial crisis in the banking industry and its Bank Insurance Fund (now exacerbated by the severe downturn in the commercial and investment real estate market) offer valid causes for concern for bank and thrift regulators. But the heated rhetoric asssociated with depository institutions often and unnecessarily spills over into the debate regarding the housing GSEs. Mr. Chairman, the distinctions between the two need to be made very clear. They are not banks; they do not accept deposits or make direct loans; they are congressionally chartered, stockholder-controlled corporations mandated to accomplish a public policy purpose through a unique corporate design.

III. H.R. 2900, THE "GOVERNMENT-SPONSORED ENTERPRISES HOUSING FINANCIAL SAFETY AND SOUNDNESS ACT OF 1991"

At our Mid-Winter Meetings in January of this year, our Association considered the issues surrounding the Government-Sponsored Enterprises. At that time, the Board of Directors reaffirmed the Association's strong commitment to the continued vitality of Fannie Mae and Freddie Mac. We believe, however, that if Congress does decide to modify the oversight and regulation of these entities, the following principles should be embodied in any new legislation enacted:

1. Congress should retain a focused housing mission for Fannie Mae and Freddie Mac to provide the American home buyer with ready access to mortgage credit through financial products and services that promote the availability and affordability of housing;

2. Congress should require capital standards that are commensurate with the degree of risk associated with housing investments in the residential mortgage market; and

3. Congress should ensure federal oversight which will balance Fannie Mae's and Freddie Mac's commitment to their housing missions with the need to manage their businesses in a prudent manner.

The NATIONAL ASSOCIATION OF REALTORS® believes that any legislative proposals should encompass the above enumerated principles. We note at the outset, however, that following the concept embodied in Principle #3 may be the most difficult task before the Congress because the decisions reached on it may have far-reaching effects not only on the GSEs but also the housing market. Hence, we believe that a

guiding precept should be that the role of the Federal government with regard to the business operations and decisions of the GSEs should remain as one of oversight only unless Fannie Mae and Freddie Mac pose a risk to the taxpayer. Inviting the Federal government to micro-manage Freddie Mac and Fannie Mae in their day-to-day business operations and intrude into management decisionmaking dilutes the discipline imposed on these entities by the private marketplace, reduces their effectiveness in their housing roles by making them less efficient businesses, and limits their financial strength by making them less attractive to investors.

The National Association of REALTORS® has considered various legislative proposals including H.R. 2900, introduced by you, Mr. Chairman. At the outset, we would like to state our support of the need to establish and maintain effective mechanisms for monitoring and managing the activities of GSEs. We believe this is the appropriate role, and indeed, the responsibility of Congress. We believe that your legislation is an appropriate start for modernizing the regulation of the housing GSEs. We believe that the basic approach to GSE capitalization and regulation embodied in your bill is reasonable and sound and the regulatory oversight framework is workable. Nevertheless, we believe that refinements can be made that will devise the optimum bill to accomplish the desired consensus.

<u>Specific Statutory Stress Test</u>

H.R. 2900 would incorporate a specific risk-based stress test that will be defined in the law. <u>The Association supports this provision because we believe that a statutory stress test provided in the legislation with very specific parameters</u>, offers the best mechanism to evaluate and monitor the housing GSEs. We believe that Congress, not an existing or unknown regulator, should determine appropriate capital standards. Only Congress has the political mandate to balance the goals of housing support with the policy of ensuring government safety.

Your legislation also includes provisions which would require Fannie Mae and Freddie Mac to set aside additional capital in the amount of 20 percent (of the capital for credit and interest rate risk) for management and operations risk, as well as authorize the Director to "increase or decrease such percentage for each enterprise as the Director determines appropriate to reflect actual management and operations risk." While the Association does not disagree with that specific percentage amount included for management and operations risk, we must respectfully submit that we are troubled by the arbitrary powers of the regulator to increase this number at will. As previously stated, we believe that the amount of capital should be set in law. Both Fannie Mae and Freddie Mac should know what their capital requirements are so business decisions can be made accordingly. <u>The National Association of REALTORS® opposes this arbitrary discretion of the regulator to change the capital level and we request that it be dropped from the Committee's final bill</u>.

Intrusive Regulatory Capital Levels for adequately Capitalized GSEs

The NATIONAL ASSOCIATION OF REALTORS® is also concerned with the considerable discretion which would be accorded to the new Director to demand additional capital when new programs and products are offered, even after the GSE has proven its adequate capitalization on the application of stress tests. This provision will force a choice between product innovation and maintaining adequate capital standards; this forced choice for Fannie Mae and Freddie Mac may not always result in housing products that will assist potential homebuyers like rural Americans or poor renters who need special housing products. When the enterprise is well-capitalized this is clearly an unneeded intrusion on corporate activities and an obstacle to product innovation that has been a hallmark for GSEs' success. The Association opposes this provision to make all new product decisions subject to a prior capital standard and we recommend that this provision be deleted.

Identity and Placement of Regulator

H.R.2900 proposes an Office of Secondary Market Examination and Oversight under the management of a Director appointed by the President with the advice and consent of the Senate, empowered to supervise the capitalization of the GSEs. The Association supports the provision in your legislation, Mr. Chairman, of the placement of the regulator within HUD because we believe that HUD can adequately regulate the GSEs if given the staff expertise to do so. However, we are concerned that this alternative perpetuates the separation of safety and soundness supervision from programmatic oversight. While financial safety and soundness are, indeed, appropriate concerns, we believe that one of these two objectives should not be given prominence at the expense of the other. While the Association prefers that the "safety and soundness regulator" be in a separate bureau within HUD, as opposed to the Treasury Department, we would go one step further and suggest, that ideally, the safety and soundness regulator and the program regulator be one and the same. If the program regulator and the safety and soundness regulator were the same, this would eliminate any potential "whipsawing" for Fannie Mae and Freddie Mac in their efforts to gain approval of new products to meet the HUD Secretary's own requirement concerning low- and moderate-income housing with the new Director's capital standard.

Affordable Housing

H.R.2900 proposes to make several changes to the manner in which Fannie Mae and Freddie Mac provide low- and moderate-income housing. In particular, the legislation would require both Fannie Mae and Freddie Mac to devote 20 percent of their prior year dividends to a housing program for low and moderate income persons.

Mr. Chairman, the NATIONAL ASSOCIATION OF REALTORS® is firmly committed to expanding the opportunities for affordable housing for this nation's population, and we support the principles on which your affordable housing provisions are based. Providing access to decent, affordable housing is a key step to building a better citizen and building a better nation. There is no better citizen than someone who owns his or her own home. More importantly, the nation as a whole stands to prosper through enhancement of affordable housing initiatives. Affordable housing is paramount to the development of a competitive local economy. Localities trying to attract new residents and create new jobs impede their own progress if they cannot provide housing that is accessible to the workforce.

We are all too painfully aware that the diminished Federal role in housing has underscored more than ever the severe need for local housing initiatives. Individuals who choose to leave the development of affordable housing to the Federal government are only kidding themselves. It is clear that a greater portion for the care and maintenance of the welfare of our communities must shift to the private sector.

While we firmly support the principle, we believe the proposed financing mechanism -- diversion of a set percentage of the GSEs' dividends -- is an inappropriate method to achieve very laudable objectives. Therefore, we must reluctantly oppose these provisions.

As you are aware, Mr. Chairman, in FIRREA, NAR supported the establishment of a similar affordable housing program with a similar financing mechanism within the Federal Home Loan Bank (FHLBank) System. Under the affordable housing provisions, the FHLBanks are required to set aside a specified percentage of their dividends to be used to subsidize interest rates on advances to member institutions that make loans for long-term affordable low- and moderate-income housing at subsidized interest rates. We believed then -- and we believe now -- that the tax-exempt FHLBanks' dividend contribution was the appropriate means for assuring that these entities help meet critical community investment and affordable housing needs.

While somewhat similar comparisons can be drawn between the statutory missions of the FHLBanks and the housing GSEs, comparisons must end at this point. The fact remains that the FHLBanks differ substantially from Fannie Mae and Freddie Mac. To compare them is to compare apples with oranges. It is for this reason that attempting to implement a FHLBank-like affordable housing program within Fannie Mae and Freddie Mac will not produce the sought after results, will have adverse effects on the entities' operations, and more importantly, will not use in the most effective way, the power of their financing capacity.

Fannie Mae and Freddie Mac are strong because they are private corporations held accountable to the market. They pay federal income taxes. They are responsible to their shareholders to perform well and earn consistent returns.

These strengths are the linch pin for the very success of the secondary mortgage market. Both Fannie Mae and Freddie Mac leverage their many dollars of capital (generated by retaining profits) into hundreds of times the number of dollars in all levels of housing, particularly low- to moderate-income. In our view, the most effective way to the the biggest bang for the buck out of Fannie Mae and Freddie Mac is not to lessen, but rather, to further extend the power of their financing capacity.

To that end, we are pleased by Fannie Mae's announcement of its pledge to commit $10 billion to affordable housing initiatives as well as Freddie Mac's renewed commitment to multi-family housing.

We also want to note, for the record, the far-reaching salutory impact this commitment is already having in terms of providing housing. On July 10, 1991, this Association and the U.S. Conference of Mayors (USCM) announced the selection of 11 cities as demonstration sites for affordable housing programs to be initiated through a joint effort involving the local board of Realtors and the mayor in each community.

A critical component to the success of this public-private housing partnership is the involvement of Fannie Mae and Freddie Mac. Mr. Chairman, both of these entities have pledged to make financing available through their low- and moderate-income housing initiatives for the local programs. The secondary mortgage market entities will be offering financial assistance, such as a low-down payment mortgage program, through local lenders.

We believe, Mr. Chairman, that the alliance of the NAR, the USCM and Fannie Mae and Freddie Mac represents the triumverate of future successful affordable housing programs: marketing to individual families, public sector support and local perspectives on housing needs. More importantly, however, is that the NAR-USCM effort will enable Fannie Mae to expand the reach of its $10 billion commitment to finance affordable housing.

IV. H.R. 2747, THE "GOVERNMENT-SPONSORED ENTERPRISES FINANCIAL SAFETY AND SOUNDNESS ACT OF 1991"

While your letter of invitation does not include a request for our comments on the Treasury proposal, H.R. 2747, the "Government-Sponsored Enterprises Financial Safety and Soundess Act of 1991", we would, nonetheless, like to address some concerns we have for the record.

Safety and Soundness Versus Housing Mission

The Treasury proposal is predicated on a conclusion that financial safety and soundness should have primacy over Fannie Mae and Freddie Mac's housing mission. The National Association of REALTORS® believes that these two principles should be balanced. If safety and soundness are the prime goals of these housing GSEs, then Fannie Mae and Freddie Mac would not produce any innovative housing products and would not participate in any riskier housing programs, including multifamily housing programs which tend to be riskier than other housing programs.

Capital Standards

The capital standards proposed by the Administration clearly reflect a determination to use banking-like capital requirements that are arguably inconsistent for the business that housing-related GSEs pursue. In addition, the proposed capital levels are excessively stringent. For example, as defined by the proposal, Freddie Mac's current capital is below the "leverage level", despite the corporation's Standard and Poor's rating of A-plus in the latest Treasury report. (In fact, Freddie Mac could be subject to conservatorship immediately upon enactment of the Administration's bill in its current form.) While the Administration proposes a safe harbor, only GSEs that receive a AAA-rating from two nationally recognized statistical rating organizations could ever expect to use it, especially when considered along with the three-part definition of capital currently proposed. Under current marketplace conditions, no corporation with a rating of A or better would be subjected to the additional stringent capital requirements contemplated by the Administration's plan.

Finally, the Association supports capital standards in statute, as opposed to leaving the capital standards up to the discretion of the regulator. As previously stated, the Association believes that Congress should be the entity that balances that dual goal of the housing mission with safety and soundness. Congress should be the entity that balances the housing mission with no risk to the taxpayer.

CONCLUSION

The NATIONAL ASSOCIATION OF REALTORS® strongly supports the activities and public policy mission of the federally chartered secondary mortgage market corporations. Their role is crucial and necessary in the home mortgage finance system. Their prudent operation and their success in meeting their public policy goals reaffirms that the role and structure Congress has mandated is proper.

Federal oversight of GSE activity is appropriate and necessary, through HUD as mandated by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). We are confident that HUD will fulfill its charge, regulating Fannie Mae and Freddie Mac from a perspective that will benefit homeownership and enhance the capacity for this nation to meet its rental housing needs.

We strongly support federal oversight and regulation of these GSEs to assure their continued operation in a safe and sound manner. We also believe that the nation's housing agency is the appropriate regulator for housing specialized GSEs, and that HUD will recognize the importance of both Fannie Mae and Freddie Mac in the mortgage delivery system, and provide a regulatory structure that will encourage their continued prudent business practices in providing consistent, affordable mortgage capital for American homebuyers.

STATEMENT

of

THE NATIONAL ASSOCIATION OF HOME BUILDERS

before the

SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT

of the

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

on

THE SUPERVISION AND REGULATION OF FANNIE MAE, FREDDIE MAC AND THE FEDERAL HOME LOAN BANK SYSTEM

July 19, 1991

INTRODUCTION

Mr. Chairman and members of the Committee, I am Paul Barru, a builder from Littleton, Colorado. I currently serve as Chairman of the Standing Committee on Mortgage Finance of the National Association of Home Builders (NAHB). In that capacity, I have had extensive exposure to the housing-related government-sponsored enterprises (GSEs) -- the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal Home Loan Bank (FHLB) System -- as well as through my personal business dealings. On behalf of NAHB and its 153,000 member firms, I am pleased to have this opportunity to appear before you to discuss the supervision and regulation of these entities, particularly with respect to their safety and soundness, and their roles in the housing finance markets.

Mr. Chairman, I want to commend you for the active role you have taken in developing legislation to modernize the supervision and regulation of Fannie Mae and Freddie Mac. While there is broad agreement that the current regulations pertaining to Fannie Mae and Freddie Mac are outdated and that major changes are needed to maintain the vitality of the FHLB System, the challenge currently facing the Congress is how to make the necessary changes without weakening the critical role these enterprises play in meeting the housing needs of American families. You and the members of this committee understand better than anyone else in Congress the increasingly critical role which Fannie Mae and Freddie Mac have played in our housing finance system in the wake of the thrift crisis and the recent turbulence in the commercial banking system. There is no greater evidence of the crucial importance of Fannie Mae and Freddie Mac than the fact that today, because of their programs and activities, there is no credit crunch in the home mortgage market, despite the shrinkage of the thrift industry and the weakening of programs vital to housing in the past. As the thrift industry continues to shrink and until problems in the commercial banking industry are resolved, Fannie Mae's and Freddie Mac's role in providing mortgage money for homebuyers will continue to grow. Furthermore, the major changes to the nation's finance system that your Committee recently advanced reinforce the need for a viable Federal Home Loan Bank System to ensure a support system for community-based lenders.

In addition to the need for the housing-related GSEs to take up the slack in the mortgage market left by the shrinking thrift industry, two other factors have in recent years led to an increased need for these enterprises. Those are:

- The government's retreat from housing programs in the 1980s. The need for housing programs did not decline along with the federal government's resolve and budget cuts. Rather, the market turned increasingly to Fannie Mae, Freddie Mac and the Federal Home Loan Bank System to provide a growing share of housing funds.

- Increasing demands on Fannie Mae, Freddie Mac and the Federal Home Loan Bank System to provide affordable housing programs.

Today, you have requested our input on this Committee's proposed legislation to improve the supervision and regulation with respect to financial safety and soundness of Fannie Mae, Freddie Mac and the FHLB System. Before addressing the specifics of your proposal, I will review Fannie Mae's and Freddie Mac's public purpose and the critical role they have played in U.S. housing policy. I will conclude my remarks with a summary of NAHB's position on the importance and future role of the FHLB System.

PUBLIC PURPOSE OF FANNIE MAE AND FREDDIE MAC

Fannie Mae and Freddie Mac were created by Congress to play an integral role in federal housing policy by providing assistance to the secondary mortgage market. Since their creation in 1938 and 1970, respectively, Fannie Mae and Freddie Mac have evolved into critical components of this nation's housing delivery system. That we have become the best housed nation in the world is due in large part to the contributions Fannie Mae and Freddie Mac have made to that system.

In 1990, Fannie Mae and Freddie Mac supplied the funds for over half of all conventional mortgages originated. This represents a ten-fold increase over the 5 percent they supplied in 1980. Also, Fannie Mae has taken a number of innovative steps over the last several years aimed at providing more mortgage money for low- and moderate-income individuals, and Freddie Mac has embarked on an effort to do the same. Particularly in view of the significant shrinkage which is occurring in the thrift industry in the wake of FIRREA and the recent turbulence in the commercial banking industry, it is clear that Fannie Mae's and Freddie Mac's importance in the mortgage market will only continue to grow.

Fannie Mae and Freddie Mac have, to date, succeeded in meeting these growing demands for their services by expanding the base of investors in mortgages and by reducing costs to the homebuyer. Fannie Mae and Freddie Mac have brought standardization to the mortgage market and have created liquid, safe, sound investments which appeal to traditional and nontraditional investors. Particularly notable is their work in developing an international market for U.S. mortgage investments. Today, Fannie Mae and Freddie Mac are able to tap both domestic and foreign capital markets for housing funds. Fannie Mae's and Freddie Mac's securities, and the secondary market they have supported, have become important mechanisms for disposing of the Resolution Trust Corporation's (RTC's) assets. As a consequence of the quality, standardization and liquidity brought to the mortgage market by Fannie Mae and Freddie Mac, costs to homebuyers have been reduced by about 50 basis points.

Pursuant to Congressional intent, Fannie Mae and Freddie Mac have always been there, through bad times as well as good. This includes the period in the early 1980's when interest rates soared, the refinancing boom of 1986-87, and the recent decline of the traditional mortgage provider in the market -- the thrift industry. Congress assured that Fannie Mae and Freddie Mac would always be there by providing them with a single purpose -- the provision and facilitation of residential finance.

Congress also provided Fannie Mae and Freddie Mac the means to accomplish their mission by granting them certain benefits or federal attributes, including exemption from SEC registration requirements and a $2.25 billion backstop line of credit to the Treasury which implies a federal guarantee. These represent two of the attributes which give rise to the market's perception of Fannie Mae's and Freddie Mac's "agency status," which in turn allows the entities to borrow at lower costs and have more favorable access to the credit markets. It should be noted that, although Fannie Mae has possessed its backstop line since 1954, it has never had to tap into its government line of credit, even in the early 1980s when a maturity mismatch in its balance sheet resulted in significant losses. Freddie Mac just received its Treasury line of credit with the passage of FIRREA, and never needed infusions of federal funds previously while part of the Federal Home Loan Bank System.

Along with these federal benefits have come responsibilities and accountability. Fannie Mae and Freddie Mac are two of the most, if not the most, closely scrutinized corporations in the world. They are accountable to their shareholders as well as to the public through oversight by HUD, the Department of the Treasury, Congress and the President through his appointees to each of their Boards of Directors. Today's hearing serves as an illustrative example of Fannie Mae's and Freddie Mac's public accountability and testimony to the fact that the public-private partnership envisioned by Congress is working. Indeed, this hearing constitutes another step in the evolutionary process by which we create and maintain a reasoned, informed policy for the provision of affordable housing.

This hearing also provides testimony to Fannie Mae's and Freddie Mac's success in their housing mission. They have done precisely what they were created to do, and they have done it well, accounting today for over half of the conventional mortgage market, and two-thirds of the loans conforming to the mortgage limits established by Congress. Yet ironically, in the wake of the thrift crisis, this very success has raised fears by some that Fannie Mae and Freddie Mac could precipitate a new multibillion dollar bailout.

At the heart of the capital adequacy issue lies the question of risk. Large losses in the thrift industry have raised concerns about the risk posed to the federal government by GSEs like Fannie Mae and Freddie Mac. At the root of these concerns is the fear that the government could have to make good on the roughly $800 billion of Fannie Mae's and Freddie Mac's outstanding debt and mortgage-backed securities.

Sheer size, in and of itself, does not constitute risk. To meaningfully evaluate the risks posed by Fannie Mae and Freddie Mac, one needs to analyze the credit and interest rate risk to which they are exposed and the measures they have taken to insulate themselves from those risks. As you know, over the past year a number of

studies have been conducted to evaluate Fannie Mae's and Freddie Mac's risk exposure. Five federal agencies -- Treasury, the General Accounting Office (GAO), the Congressional Budget Office, the Office of Management and Budget and HUD -- have looked at this question. In addition, Fannie Mae and Freddie Mac themselves commissioned independent studies: Fannie Mae's was conducted by James O. Wolfensohn, Inc., under the direction of Paul Volcker, and Freddie Mac's was done by Price-Waterhouse. Importantly, all of the studies concluded that Fannie Mae and Freddie Mac are adequately capitalized and do not pose a risk of a taxpayer bailout, similar to that of the thrift industry.

Thus, based on the clean bill of health from all these studies, the primary concern of the Congress should not be bailouts, but balance. The challenge currently facing the Congress is how to achieve the appropriate balance between Fannie Mae's and Freddie Mac's housing mission and their financial well-being. We believe that there are three primary factors necessary to achieve this balance: (1) a regulator capable of balancing housing mission with safety and soundness, (2) capital requirements based on actual risks undertaken by these enterprises, and, (3) adequate examination, supervision and enforcement powers.

HUD IS APPROPRIATE REGULATOR FOR FANNIE MAE AND FREDDIE MAC

NAHB strongly believes that HUD is the appropriate Federal agency to oversee both the program responsibilities and the safety and soundness of Fannie Mae and Freddie Mac. We see no reason for an independent "super-GSE" regulator such as that proposed by GAO. Such a regulator would lack the housing expertise necessary to pass realistic judgments on Fannie Mae and Freddie Mac.

The safety and soundness of Fannie Mae and Freddie Mac are best regulated by an entity with expertise in and support for their housing missions. These functions, which are the very essence of HUD, are essential for judging the performance of these housing GSEs. Indeed, it is precisely for this reason that Congress placed regulatory oversight of Fannie Mae and Freddie Mac with HUD.

NAHB acknowledges that HUD has come under criticism in carrying out its regulatory role. Nevertheless, we believe that there are sound reasons for retaining HUD's oversight of these secondary market entities. HUD understands the housing support and mortgage credit role that these corporations fulfill and thus can strike the proper balance between mission fulfillment and financial well-being. We are confident that a structure can be established within HUD, such as that proposed by the Committee and Treasury, that has the technical expertise and independence to effectively monitor both the programs and safety and soundness of Fannie Mae and

Freddie Mac. To carry out these functions, HUD should be given the financial and management support necessary to monitor and evaluate these entities and to enforce requirements necessary to ensure that Fannie Mae and Freddie Mac maintain their financial soundness and their ability to play an integral role in providing housing and mortgage credit. We believe that the Committee's proposal, particularly the provisions which would allow HUD to hire qualified staff to carry out its supervisory functions, would provide the necessary support.

CAPITAL REQUIREMENTS TAILORED TO RISK

NAHB strongly supports the principle that Fannie Mae and Freddie Mac be adequately capitalized. The purpose of capital is to provide a cushion against losses. All the studies conducted thus far have concluded that Fannie Mae and Freddie Mac currently are adequately capitalized and would continue to be under the most severe economic conditions. Thus, the current focus should be on the proper approach to ensure that these entities continue to be adequately capitalized.

In general, we believe that capital requirements for Fannie Mae and Freddie Mac should promote the financial viability of these entities, but should also be sensitive to their housing mission and the unique nature of these institutions. Such requirements should be clearly related to the actual risks borne by the corporations, specifically those associated with the different types of mortgages, investment securities and guarantees provided by Fannie Mae and Freddie Mac, and should recognize the steps the corporations have taken to reduce their risk exposure.

Fannie Mae and Freddie Mac are exposed to three main sources of risk: credit risk, interest rate risk, and management and operations risk. Fannie Mae and Freddie Mac have reduced credit risk through strict underwriting, quality control and seller/servicer criteria which have lowered default rates at both agencies. Indeed, studies by both CBO and HUD have noted that Fannie Mae and Freddie Mac have lower default and foreclosure rates than the rest of the housing finance industry. Additionally, the geographic diversity of their mortgage purchases reduces exposure to adverse economic conditions in a single region of the country. For example, when the Southwest suffered economic distress, purchases from other regions served as a buffer.

Fannie Mae and Freddie Mac have reduced their interest rate risk through simultaneous sales of mortgages that they purchase through their mortgage-backed securities (MBS) programs. In addition, Fannie Mae minimizes interest-rate risk on its sizeable portfolio holdings by maintaining a close duration match between assets and liabilities. Freddie Mac employs a similar method for its smaller portfolio. (We note that due to mismatches in its portfolio, Fannie Mae experienced troubles in the early

1980s similar to those of the thrift industry. However, over the course of the decade, Fannie Mae took corrective action that has resulted in a current close duration match between its assets and liabilities.)

The entities currently do not capitalize for management and operations risk, but they have proposed to do so. Consistent with the recommendations of the GAO report. Fannie Mae and Freddie Mac have proposed an additional 10 percent add-on to the capital amounts needed for credit and interest rate risk to account for "unquantifiable" management and operations risk. This amount seems reasonable to us.

In principle, we believe that a reasonable stress test is the best method for measuring and monitoring capital adequacy related to credit and interest rate risk. Bank and thrift risk-based capital standards are not appropriate capital standards for Fannie Mae and Freddie Mac because of the significant differences in the nature of the business of the GSEs and that of banks and thrifts: Fannie Mae and Freddie Mac have a national presence and are better diversified geographically than banks and thrifts; Fannie Mae and Freddie Mac are restricted by statute to residential finance and cannot expand into other forms of lending; they have broad access to the national and international capital markets; and, they are assured of substantial guarantee fee income. All of these factors are ignored by the bank and thrift risk-based capital rules.

However, we do not believe that economic stress tests should be used as an exclusive measure of capital adequacy. Results of stress tests should be balanced against internal management and risk control measures (such as underwriting, quality control and seller/servicer criteria) which both entities employ to reduce their risk exposure. Further, the implications of the stress tests should be balanced against Fannie Mae's and Freddie Mac's housing mission. Excessive capital requirements based solely on the results of the stress tests could impair the ability of these entities to perform their housing mission.

Besides stress tests, we also believe that there should be a minimum capital standard to provide a base capital cushion. However, this standard should not be so high as to impede the operations of these entities and unnecessarily impact mortgage credit availability and affordability.

Finally, and perhaps most important, NAHB strongly believes that the methodology and assumptions used in establishing capital standards should be thoroughly specified in statute. Giving the regulator complete discretion to establish capital standards, as Treasury has proposed, could result in an excessively high capital standard that would have a damaging impact on the housing and mortgage markets. As the CBO study recognized, any standard that requires Fannie Mae and Freddie Mac to hold significantly higher capital than they currently do could result in higher interest costs for homebuyers and reduce the ability of the corporations to perform their

housing mission. Further, as the Committee points out in its analysis of the Treasury proposal, because of such regulatory discretion there would be no way for the Congress to balance housing mission with risk since Congress would not know what the eventual risk level would be. Only Congress can provide the necessary balance by adopting clear mechanics for a system of capital standards in statute.

In general, the Committee's proposal meets these broad parameters. As specified in the Committee print, the Committee proposes three levels of capital standards. First, a risk-based capital level based on stress tests that measure interest rate and credit risk, plus an additional amount to cover management and operations risk. The Committee's proposal adopts the stress test definitions for credit and interest rate risk proposed by Fannie Mae and Freddie Mac, but doubles the amount the enterprises have proposed for operations and management risk. Specifically, the proposal would require sufficient capital to withstand credit risk against a nationwide real estate depression for at least 8 years and, for interest rate risk, sufficient capital to withstand interest rate increases or decreases of 50 percent up to 500 basis points for 8 years. The Committee proposes an additional 20 percent add-on to cover management and operations risk and provides the regulator discretion to increase (or decrease) this amount if the regulator believes this is warranted to reflect actual management and operations risk.

The second capital level establishes a minimum capital standard, or leverage limit, on both a mark-to-market and GAAP basis. The minimum capital standard proposed by the Committee adopts the standards proposed by Fannie Mae and Freddie Mac: mark-to-market equity of 2 percent of on-balance sheet assets and 1 percent of off-balance sheet assets and a GAAP component of 1.5 percent of on-balance sheet assets and .5 percent of off-balance sheet assets. One significant difference between the Committee's proposal and that of the enterprises, is that the Committee's proposal would require the corporations to meet the minimum capital level without counting loss reserves.

In contrast, the Treasury proposal sets a leverage limit of 2.5 percent of on-balance sheet assets and .45 percent of off-balance sheet assets, both measured on a GAAP basis. Fannie Mae currently meets this limit, while Freddie Mac falls slightly below it. Treasury's proposed risk-based capital standard would, presumably be significantly higher than the leverage limit.

The third, and final, capital level proposed by the Committee is a critical capital level equal to one-half of the minimum capital level. Treasury and Fannie Mae and Freddie Mac have also proposed critical levels equal to one-half of their respective minimum capital levels.

NAHB believes that the Committee's approach to capital standards is superior to that proposed by Treasury. The specificity in the descriptions of the stress tests for capitalizing credit and interest rate risk provide a more reasonable and dynamic system of capital standards than that proposed by Treasury. In addition, the Committee's proposed standards are more consistent with the results of the several studies on the capital adequacy of Fannie Mae and Freddie Mac. As noted, all studies found that these corporations are adequately capitalized and able to withstand the severest of economic downturns. Yet, Treasury's proposal implies that the minimum risk-based level should be at a level significantly above the corporations' current capital positions. This proposal is not supported by any of the studies, including Treasury's.

Nevertheless, while we generally support the Committee's proposed capital standards, we have several concerns with the proposed capital add-on for management and operations risk. The proposed 20 percent add-on for management and operations risk seems unjustifiably high. As noted, GAO recommended an add-on of 10 percent. A 20 percent add-on would be ten times the loss incurred from Freddie Mac's multi-family experience. We do not believe it necessary to maintain this much additional capital. Further, we are concerned that the discretion given to the regulator to increase this amount could adversely affect the housing market should this level be set too high. Both the CBO and GAO studies cautioned that requiring too much capital could result in higher mortgage rates to homebuyers as Fannie Mae and Freddie Mac increased fees to add to capital. In addition, while we understand that given the "unquantifiable" nature of management and operations risk some discretion to increase this amount may be warranted, we are concerned that not only the amount, but also uncertainty over future adjustments could prevent Fannie Mae and Freddie Mac from taking the risks to serve housing, through new product innovation or maintenance of existing housing programs with significant management risks. For these reasons, we strongly urge the Committee to reduce the add-on for management and operations risk to 10 percent and to establish an upper bound for discretionary additions to capital standards for management and operations risk.

ADEQUATE REGULATORY POWERS

In addition to establishing capital standards, the Committee proposes that the regulator would have the power to enforce compliance with these capital standards, review the capital adequacy of new programs, and conduct examinations and audits of the corporations. NAHB believes that the enforcement and other powers granted the regulator under the Committee's proposal are better calibrated to relative levels of capital compliance and less disruptive to the achievement of the housing mission of Fannie Mae and Freddie Mac than are the provisions contained in the Treasury proposal. Nevertheless, we have concerns with several of the provisions the Committee proposes.

NAHB recognizes the importance of allowing Fannie Mae and Freddie Mac ample leeway to respond in innovative ways to the nation's housing needs, and feels that the level of regulatory intrusion allowed in the Treasury proposal will block and stifle the creativity of these enterprises. Even the Committee's bill, which allows much less regulatory intrusion, opens the possibility that time-consuming reviews and unfavorable capital assessments of new programs will hamper and even prevent Fannie Mae and Freddie Mac from launching needed new programs and products. The impact of stifling regulation could be particularly devastating to efforts aimed at lower-income households, because such programs typically must stretch conventional underwriting standards and take new and untried paths. Such programs also could be irreparably damaged by excessive capital assessments.

NAHB does not believe, however, that compliance with capital standards should mean that Fannie Mae and Freddie Mac operate completely outside program approval and review. We feel that reasonable approval and review mechanics can be established to ensure that Fannie Mae and Freddie Mac continue their impressive string of program and product innovations. Any such reviews should be required to be completed within a period not to exceed 60 days, with no latitude for additional delays. While new and existing programs should be viewed within the context of the entities' capital adequacy, marginal capital requirements should not block the creativity that is needed to fulfill their housing mission. While approval and review should not be overly intrusive, the regulator should be granted the capacity to assure that the entities are operating within the bounds of their charters and responding adequately to the full range of the nation's housing finance needs.

Further, NAHB believes that it is vital that any final GSE legislation clearly outlines that regulatory responsibilities will be coordinated within HUD. We are concerned that new regulatory mandates may conflict or overlap with those established in FIRREA and previously, and that the resulting confusion and possibly contradictory direction could dangerously stall operations of these key components of the housing system.

AFFORDABLE HOUSING PROVISIONS

Under their charters and the direction of FIRREA, Fannie Mae and Freddie Mac should display a strong leadership role in the financing of housing for low- and moderate-income families. In fact Fannie Mae has established a strong and impressive track record in this area. The corporation played a key role in providing homeownership opportunities and affordable rental housing to low-and moderate-income families well before being required to do so in FIRREA. Freddie Mac, though

starting later, also has moved strongly to establish financing programs directed to the needs of low- and moderate-income families.

In the case of Fannie Mae, in 1987 the corporation created an Office of Low- and Moderate-Income Housing. Since this office was created Fannie Mae has committed to invest more than $15 billion in such activities. This includes:

- more than $2 billion in commitments under single-family community lending programs. In these programs, Fannie Mae works with local agencies, community groups and other organizations to make home purchases possible for families that can not access conventional financing channels;

- the purchase of nearly $3 billion in mortgage revenue bonds and other tax-exempt bonds from state and local housing finance agencies, which are issued to fund mortgages for low- and moderate-income first-time homebuyers as finance rental housing for such families;

- the provision of credit enhancement for another one-half billion dollars in tax-exempt bonds;

- commitments of more than $200 million in capital for rental projects using the low-income tax credit program. All of these projects serve families with incomes of no greater than 60 percent of the area median;

- continued program innovations to stretch the range of housing needs met, including the "3/2" program that allows borrowers greater flexibility to cope with downpayment requirements and a program to support employer-assisted housing.

Fannie Mae has been extremely active in seeking and forming partnerships with other organizations for synergistic solutions to affordable housing problems. Fannie Mae is working with the AFL-CIO Housing Investment Trust to finance rental projects to serve low-income families; with state governments like Pennsylvania and New Jersey to provide affordable home loans; with the Federal Home Loan Banks to create a security to help Federal Home Loan Bank System members access the System's Affordable Housing Program; and, most recently announced a program to provide a secondary market for affordable rural mortgage loans guaranteed by the Farmers Home Administration. Fannie Mae is also working with housing trade associations, including NAHB, to produce affordable housing.

Freddie Mac, we are pleased to say, has also been active in developing programs to finance the housing of lower-income families. The corporation recently committed $3 billion to such programs over the next 18 months. Most recently, Freddie Mac teamed up with the AFL-CIO to provide assistance to union members buying their first

homes. In addition, Freddie Mac is working with the state of Michigan to expand homeownership opportunities of its lower income residents. Freddie Mac is also a major player in the National Community Development Initiative, an effort to expand the availability of low-income rental housing by providing a secondary market for $100 million in low-income rental housing mortgages. The corporation also is providing secondary support to a variety of community-based affordable housing programs, and is expanding investments in low-income rental housing.

In addition to these targeted efforts, a high proportion of the mortgages purchased by both Fannie Mae and Freddie Mac in their standard programs are for amounts far below their statutory limits, and these purchases clearly benefit lower income families. For example, in 1990, despite a loan limit of $187,450, the average single-family mortgage purchased by Fannie Mae and Freddie Mac was $89,700 and $87,000, respectively. Moreover, nearly one-third of the loans purchased by the corporations had balances below $60,000. Additionally, each corporation has recently moved to incorporate its low- and moderate-income housing activities within the mainstream of its business.

NAHB believes that Fannie Mae and Freddie Mac both have a strong commitment to meeting the housing needs of low- and moderate-income families, and that the corporations have been on the cutting edge of innovative financing efforts in the area of affordable housing. We object to statutory, or even regulatory, requirements for affordable housing efforts that are so narrow as to tie the hands of the corporations in carrying out this part of their mission. The Committee's proposed dividend set-aside provision would have such an effect. Fannie Mae and Freddie Mac have been extremely creative and successful in addressing affordable housing needs and they must be allowed to retain a great deal of flexibility in doing so. Furthermore, while NAHB believes that the operations of Fannie Mae and Freddie Mac should be periodically reviewed to ensure that the benefits of their government ties are adequately passed on to homebuyers and renters, rather than being excessively expended in dividend payouts or internal operating costs, the Committee's proposed requirement of regular (which could mean daily) fee and price monitoring (to ensure that the dividend set-aside is not funded through increases in mortgage yields and fees) would be an operational nightmare that would smother the corporations' ability to function. Mortgage yields vary in the short-term for so many reasons (including market, competitive, and risk-related purposes) that it would be difficult to determine if yields had been increased to ensure compliance with this requirement. Any such analysis would need to cover a lengthy period of time -- a quarter of the year, or possibly longer.

IMPORTANCE AND FUTURE ROLE OF THE FHLB SYSTEM

Title IV of the Committee's proposal establishes the safety and soundness of the Federal Home Loan Bank (FHLB) System as the primary responsibility of the Federal Housing Finance Board (FHFB). The FHLB System is very strongly capitalized, and, in fact, capital adequacy is not an issue for the System. What is at issue, however, is how to make the Bank System work more effectively to support residential finance while maintaining and enhancing its solid financial profile.

The FHLB System was established more than 50 years ago to serve several public policy objectives. One of these is to ensure liquidity in the deposit system. The second, and more important, is to promote homeownership by making mortgage credit consistently available and affordable. To these have been added a significant financial responsibility for the funding of the thrift bailout. However, the FHLBs will not be able to remain a critical force in carrying out these public policy objectives in an environment of shrinking System membership and declining FHLB earnings and capital. The System's primary source of income -- advances to members -- has fallen off dramatically. Since July 31, 1989, just before the passage of FIRREA, FHLB advances have declined 41% while the System's assets have declined by 21%.

The FHLB System has the potential to be much more than an eroding support system for a shrinking thrift industry. The FHLB System is at a crucial juncture where its resources should be redirected to bring it back into the mainstream of the housing funding process. The System could play an important role in providing other types of credit services, such as loan purchases, participations and credit guarantee instruments, that would help its members to manage their lending activities with greater flexibility. This would help members diversify portfolios and meet demands for new lending that might otherwise be constrained by loan-to-one-borrower limits or asset concentration considerations that could otherwise discourage them from putting real estate loans on their books.

To achieve its public policy goals and obligations, the FHLB System must be allowed the latitude and the capacity to expand its focus from the declining thrift sector and to re-establish itself in the mainstream of the housing finance system. The problems of the System--eroding membership, declining traditional advances, and declining earnings--need to be addressed if the Banks are to attract and sustain a strong membership, create earnings opportunities, generate capital, and serve the broad spectrum of the housing industry as a financially sound credit support network.

Several of these problems can and should be addressed immediately. These include equal access to advances by nonthrift members and unlimited use of residential

assets as collateral for FHLB advances. Other changes to the System -- new credit products and services -- may require further study before legislative action is taken.

NAHB Recommendations for Immediate Changes:

1. **Equal Access to Advances by Nonthrift Members**

The marginal stock purchase requirement for advances, which is tied to the Qualified Thrift Lender (QTL) test, should be changed in order to eliminate the disadvantages inherent for nonthrift members. While QTL thrifts may borrow $20 per $1 of stock owned, nonthrifts (which almost by definition will not meet the QTL test) may borrow only at a ratio that declines significantly in proportion to the size of their actual mortgage asset portfolio.

Nonthrift members face further discrimination in advances by the provision in the FHLB Act that prohibits any Bank from having more than 30% of its advances outstanding to nonthrift members. Several Banks are approaching that limit now, and they will be forced to curtail their lending and impair their earnings potential if this limit remains in effect.

To correct these inequities, we urge Congress to eliminate Section 10(e)(1) of the FHLB Act, which now requires that members that do not meet the thrift QTL be subject to borrowing limits. We also urge Congress to delete Section 10(e)(2) and thereby eliminate the 30% cap on the amount of advances that a Bank may have outstanding to nonthrift members.

2. **Collateral for Advances**

The caps on the amount of housing-related assets that member institutions can use to collateralize advances should be removed. Currently, only a narrowly defined group of government securities, first mortgages and mortgage-backed securities may be used without restriction to secure advances. There are substantial restrictions on the use of participation interests in residential loans, residential production loans, nontraditional mortgage-related securities, and nonresidential real estate as advance collateral. Such collateral may not, in combination, exceed 30% of the member institution's capital.

NAHB strongly urges Congress to remove the caps on eligible residential-related collateral, but not for nonresidential real estate, by amending Section 10(a) of the FHLB Act accordingly.

<u>Study on Credit Products and Services:</u>

NAHB believes that one or more studies should be conducted at the federal level, which would evaluate the roles of the FHLB System in promoting residential finance. In particular, the study should determine what actions are necessary to (1) sustain financial stability in the Bank System; (2) expand the role of the System as a support mechanism for community-based housing lenders; and (3) enhance its members' ability to provide credit for both the consumers and producers of housing.

CONCLUSION

In summary, let me reiterate that NAHB strongly supports the safety and soundness of Fannie Mae and Freddie Mac, balanced against the housing mission of these corporations. We believe that the Committee's proposal comes close to achieving this balance between financial well-being and public purpose and is superior to the Treasury's proposal which would impose unnecessary and excessive regulations that would impede the ability of these corporations to perform their integral role in the housing finance market.

NAHB strongly believes that HUD is the appropriate regulator to oversee both the program and financial responsibilities of Fannie Mae and Freddie Mac. We generally support the Committee's approach to capital standards for these entities and believe that the Committee's proposal is superior to that proposed by Treasury because of its specificity and the linking of these standards to the actual risks of the corporations. NAHB also believes that the enforcement and other powers granted the regulator under the Committee's proposal are better calibrated to relative levels of capital compliance and less disruptive to the achievement of the housing mission of Fannie Mae and Freddie Mac than are the provisions contained in the Treasury proposal. However, we do not believe that compliance with capital standards should mean that Fannie Mae and Freddie Mac operate completely outside of program approval and review.

In the area of affordable housing, NAHB believes that Fannie Mae and Freddie Mac both have a strong commitment to meeting the housing needs of low- and moderate-income families, and that the corporations have been on the cutting edge of innovative financing efforts in the area of affordable housing. We object to statutory, or even regulatory, requirements for affordable housing efforts that are so narrow as to tie the hands of the corporations in carrying out this part of their mission. We caution that the Committee's proposed dividend set-aside provision would have such an effect.

Finally, we believe that the Federal Home Loan Bank System, is at a crucial juncture where its resources should be redirected to bring it back into the mainstream of the housing funding process. The System could play an important role in providing other types of credit services, such as loan purchases, participations and credit guarantee instruments, that would help its members to manage their lending activities with greater flexibility. To achieve its public policy goals and obligations, several problems should be addressed immediately. These include equal access to advances by nonthrift members and unlimited use of residential assets as collateral for FHLB advances. Other changes to the System -- new credit products and services -- may require further study before legislative action is taken.

As this Subcommittee, and the entire Congress, deliberates in the upcoming weeks how to update the supervision and regulation of the housing-related GSEs with respect to safety and soundness, I hope the comments I have made verbally and in writing today will be considered in the constructive spirit in which I have made them. Thank you again for giving NAHB the opportunity to be part of your GSE supervisory and regulatory reform efforts.

STATEMENT OF

DAVID F. HOLLAND

CHAIRMAN AND CEO

BOSTON FEDERAL SAVINGS BANK

BURLINGTON, MASSACHUSETTS

ON BEHALF OF THE

U.S. LEAGUE OF SAVINGS INSTITUTIONS

BEFORE THE

SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

UNITED STATES HOUSE OF REPRESENTATIVES

JULY 19, 1991

SUMMARY

The three government-sponsored housing enterprises (GSEs) now have on- and off-book liabilities which exceed those of the surviving thrift business and amount to one-third of the total liabilities of the commercial banking industry. Given this situation, the U.S. League of Savings Institutions believes that it is essential that a new and improved framework be developed to regulate and supervise these entities.

In this regard, we want to commend the sponsors of the proposed, "Government-Sponsored Housing Enterprises Financial Safety & Soundness Act of 1991." We believe this proposed legislation sets the stage for the creation of the new framework that is so badly needed.

Further, we want to offer our very strong support for the proposed efforts to increase the availability of financing for affordable housing and to improve the safety and soundness of these housing GSEs. Still, we would urge the Subcommittee to go further in both of these areas.

With respect to affordable housing, we strongly support the provisions to improve the targeting of Fannie Mae and Freddie Mac lending to low- and moderate-income families. We applaud your definitions of these groups. We would respectfully suggest, however, that the Congress determine in statute the appropriate percentage of these entities' lending that should go to families in need. We believe this percentage should be significant (e.g. one-third) and that it should be increased over each of the next several years. Furthermore, where the proposal stipulates that these loans provide a "reasonable economic return" to the agencies we would suggest that this be interpreted to mean that the agencies are able to make a reasonable return on their total portfolio rather than on these loans in isolation.

In addition, we want to strongly endorse the effort to include Fannie Mae and Freddie Mac in the affordable housing effort. We believe that the 20% of dividends figure would be roughly equal to the amount now being contributed by the FHLBanks (and would be even lower when tax-effected). We would hope that provisions could be added which provide for this percentage to increase comparably with the scheduled increases in the FHLBank program.

With respect to capital, the U.S. League believes that all financial institutions including the housing GSEs need strong capital and aggressive supervision. The debacle of the 1980s has taught us this lesson all too well. We support the application of the current international risk-based capital rules to Fannie Mae and Freddie Mac. We also support the Treasury-proposed capital rules for these two entities as a minimum.

Further, we support the CBO contention that there should be capital requirement equity between the three housing GSEs (Fannie Mae, Freddie Mac and FHLBanks). Thus, we would urge the Subcommittee to re-evaluate this issue.

Finally, the thrift industry views the future of the FHLBanks as vital to its own future. Although the FHLBank System remains strong, there are valid concerns about its future.

The Bank System has been shrinking along with the thrift business. This has not been a problem in the past but it is now with the passage of FIRREA.

As the Bank System shrinks, the $300 million lump sum annual fee paid by the Bank System for REFCORP becomes an increasingly untenable burden. We urge that this fee be changed from a lump sum to a percentage of income basis.

Regardless, we do not agree with those who suggest that the current trends at the Bank System are reason for panic. We do not support suggestions that the Bank System should get into new risky activities to boost its earnings.

Further, we are very concerned about proposals to change commercial bank membership and stock purchase requirements. We believe that the current system is fair, given existing mandatory membership and thrift QTL requirements. Of course, if we can achieve voluntary membership for all members, then we believe stock purchase and other membership requirements should be the same for all members. Any such change should only occur, however, once voluntary membership is in place.

Finally, we believe that the most desirable course for the FHLBanks in response to the shrinking demand for advances is to sharply reduce their costs. Although this is a very difficult process, it is essential.

Once again, the U.S. League of Savings Institutions strongly supports the Subcommittee's efforts. We want to thank you for this opportunity to make our views known.

Mr. Chairman and members of the Committee:

My name is David Holland. I am chairman and CEO of Boston Federal Savings Bank, a $550 million, SAIF-insured savings bank headquartered in Burlington, Massachusetts. Today, I appear before you on behalf of the U.S. League of Savings Institutions. Mr. Chairman, we greatly appreciate the opportunity afforded us to appear before your Committee.

To begin with, Mr. Chairman, we want to commend you and the other sponsors of the proposed Government-Sponsored Housing Enterprises Financial Safety & Soundness Act of 1991. We believe it is essential that the nation develop a new framework for dealing with the housing GSEs. We believe your proposals set the stage for the development of that new framework.

In particular, we want you to know that we strongly support your efforts in two areas: promoting safety and soundness and promoting low- and moderate-income housing.

During my testimony today, I want to address the major areas of this proposed legislation. We believe your proposals are essential and are headed in the right direction. We believe, however, that the proposals do not go far enough and would like to see them strengthened.

I would also like to briefly address the issue of the Federal Home Loan Bank System. As you know, the future of the FHLB System is a vital interest of the thrift business.

INTRODUCTION

Everyone associated with housing finance recognizes the vital role played by Fannie Mae and Freddie Mac in home financing. This is particularly true in the thrift industry.

Our industry has experienced unequaled turmoil over the past decade. During that time, we have used the secondary market to help us adjust our asset holdings and continue our mortgage origination efforts. Thus, we place a very high value on the liquidity provided the mortgage business by the so-called secondary market.

Even as our industry has been shrinking, we remain active in mortgage finance. Healthy firms continue to build their mortgage portfolios, and although the data show that we no longer dominate residential mortgage finance, we remain major mortgage portfolio lenders. We are also major buyers and sellers of residential mortgages and major holders of mortgage securities.

In 1990, healthy savings institutions made $96.8 billion in home purchase loans, an increase of 3.6% over 1989. Those same thrifts increased their holdings of whole mortgage loans 3.1%, from $391.5 billion to $403.4 billion. They also did a fair amount of business with the secondary mortgage market, as evidenced by a 12.5% increase in mortgage-backed securities holdings, from $93 billion to $104.6 billion.

Obviously, it is in our interest to see Fannie Mae and Freddie Mac remain strong and for the secondary market to be stable and available to the thrift business. We do not want to see anything done which would damage either of these important government sponsored enterprises (GSEs) or the secondary market.

While we value the role played by these agencies in mortgage finance, we also see them as privileged competitors. As noted earlier, the thrift industry is no longer the nation's major supplier of mortgage credit. A recent GAO study[1] makes clear that this is no longer the case. It also attempts to explain why the thrift industry's role in housing finance has been significantly reduced.

For example, the GAO observes: "Compared to earlier times, the returns from mortgages have been lowered by the development of MBS, the risk is higher because of volatile interest rates, and thrift costs have been increased by post-crisis reforms." This report goes on to note that: "The privileges once granted thrifts in return for their commitment to the business of home financing have gradually been eroded."

Add to these structural changes the shrinkage of the industry as the failures of the past are cleaned up and as viable companies adjust their assets to today's higher capital standards and many observers ask whether the business has a future. Unfortunately, the answer is not all that clear.

What we know is that there is a healthy core of thrift institutions. We know these firms have continued to specialize in housing finance and want to continue to do so. We also know that the observations of the GAO and others concerning the factors depressing thrift profitability are very real.

In our view, the time has passed for the future of the thrift business to depend upon government fiat. We no longer expect special privileges in return for our being dedicated to housing finance. We are more than willing to compete on a "level playing field" and let the marketplace determine our future.

Given such a competitive environment, we think the Congress should go about creating a system which allows thrifts and other depositories to choose their charter freely. By lowering the barriers to free movement by depositories we can allow the marketplace to decide the future of not only the thrift business but all financial institutions.

For this process to work, however, there must be every effort made to create competitive equality. In this regard, we have some significant concerns about the current treatment of the GSEs operating in the mortgage market.

---

(1) *Thrifts and Housing Finance*, U.S. General Accounting Office, Washington, D.C., April 1991.

The Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation compete with private-sector financial institutions in the mortgage market. As table 1 shows, these institutions' involvement in the marketplace has grown so explosively over the past two decades that they are now among the largest financial institutions in the world.

Table 1: Growth in FNMA and FHLMC Mortgage Holdings and Guarantees, 1970-1990

1970	$13.2 Billion
1980	$73.8 Billion
1990	$751.5 Billion

Source: *A State of Risk, Will Government-Sponsored Enterprises be the Next Financial Crisis*, Thomas S. Stanton, HarperCollins Publishers, Inc., New York, 1991, pg. 35.; 1990 Annual Reports of Fannie Mae and Freddie Mac.

These agencies enjoy three competitive advantages over other participants in the market:

1. They are subject to virtually no capital requirements and hold equity capital equal to one-quarter to one-sixth of that required of regulated, insured depositories who hold mortgages. This means that the same level of earnings at the agencies and at a private financial institution would produce at least quadruple the return on capital for the FNMA and FHLMC.

   Fannie Mae's and Freddie Mac's low capital levels not only give them a huge competitive advantage over private firms, they are also advantaged relative to the Federal Home Loan Bank System which maintains equity, as a percent of total obligations, equal to 7-1/2 times that of Fannie Mae and almost twelve times that of Freddie Mac.[(2),(3)]

(2) Computed from data in Tables 17 and 20, *Controlling the Risks of Government-Sponsored Enterprises*, Congressional Budget Office, Washington, D.C. April 1991. The CBO points out: "The capital standards for the FHLB system and the thrift industry, along with other factors, have put savings institutions at a competitive disadvantage vis-a-vis Fannie Mae and Freddie Mac in financing conventional mortgages, particularly fixed-rate loans. Unless these and other rules are changed, current trends suggest that in the long run most conventional loans will be securitized by Fannie Mae and Freddie Mac, and these two GSEs are likely to dominate the market for loans that they are eligible to purchase. ... Such a possibility raises concerns that these two GSEs could at some point exercise their market power and capture for their shareholders some of the implicit subsidy of their agency status, instead of passing it along to borrowers in the form of lower interest rates." Ibid., pp. 230-1.

(3) The low level of Fannie Mae's and Freddie Mac's capital allows them to earn extraordinary returns on that investment relative to those of the Federal Home Loan Banks:

After-Tax Return on Equity

2. The obligations that Fannie Mae and Freddie Mac issue in the marketplace are universally accepted as carrying the implicit backing of the federal government. Yet the agencies do not pay any fee to the government for that imprimatur. The deposit obligations of insured financial institutions are also backed by the government but banks and thrifts have to pay almost a quarter of a percentage point for that coverage.

3. As I mentioned previously, FNMA and FHLMC are huge financial institutions. They thereby enjoy tremendous economies of scale, which are all the more significant given their concentration in one line of business, a rather simple one at that. No private institution in the country can match those economies.

We would not object to the third of these advantages, the economies of scale the agencies can employ (except to note that they would not have been able to grow to their current size were it not for the other competitive advantages given them, particularly the ability to grow without adequate capital backing their growth). Efficiency is good for the economy and if someone, operating under the same rules, can do our job better and more cheaply than we can, then more power to them.

There is an analogy in the commercial banking business. Several observers hold that the large banks have lost their best customers -- the General Motors, General Electrics and IBMs of the world -- because the capital markets can serve these big companies more efficiently than the banks can. That is what our capitalist system is about and the nation's consumers benefit from the decreased costs.

If the private securitization of the mortgage market by Wall Street had also made life difficult for thrifts, then we also would have little to complain about. Yes, Wall Street is a big player in the secondary market for mortgages but participates primarily by trading the government-advantaged securities of the GSEs.

(Percent)

	1990	1989	1988	1987
Fannie Mae	33.9	30.7	24.9	25.1
Freddie Mac	20.4	25.0	27.6	28.2
FHLBanks	11.4	12.0	9.9	10.4

Source: *Report of the Secretary of the Treasury on Government-Sponsored Enterprises*, U.S. Treasury Department, Washington, D.C., April, 1991, pg. 1.

The stock market recognizes the unique advantages of Fannie Mae and Freddie Mac. As table 2 shows, the market value of the GSEs relative to their book value at the end of the first quarter of this year was two and one-half to three times that of the largest thrifts in the country. Many smaller publicly owned thrift institutions have even lower market-to-book values than the figures here would indicate.

Table 2: Market Value as a Percent of Book Value: FNMA and FHLMC vs. 25 Largest Thrifts
(End of First Quarter, 1991)

	Market Value As a Percent of Book Value	Ratio of GSE Value to Thrift Value
Federal National Mortgage Association	253%	3.1
Federal Home Loan Mortgage Corporation	214%	2.6
Average for Twenty-Five Largest Thrifts	83%	N/A

Source: American Banker, Wall Street Journal, FNMA and FHLMC First Quarter Report of Earnings, U.S. League of Savings Institutions.

From a public policy point of view, the difficulties the preferred position of the GSEs cause for thrifts is not the only problem -- although even here there is an impact on the taxpayer because of the added costs for the RTC of increased numbers of thrift failures and of the increased cost of disposing of those who fail. There is the additional exposure to the taxpayer from the GSEs themselves as a result of their enormous size and their low capital.

There are several ironies that arise from this situation:

1. In FIRREA and in the legislative proposals Congress is currently considering, a great deal of emphasis was, and is, being appropriately put on the importance of capital in insured depositories as a protection for the taxpayer. Many thrifts and banks have a great deal of difficulty in raising the additional needed capital. Table 2 above shows that the market would be receptive to providing additional capital to Fannie Mae and Freddie Mac whose current capital position is much lower than that being required of depositories. Yet the GSEs are being allowed to continue with their low capital positions even though it exposes the taxpayer to risk. Meanwhile raising the capital of thrifts without requiring the same of the GSEs only exacerbates the already formidable competitive edge given to the GSEs.

2. As a concomitant to risk-based capital as a risk-inhibitor, Congress is also in the process of deciding whether to impose risk-based deposit insurance premiums on

insured institutions. Yet Fannie Mae and Freddie Mac are allowed to operate at capital levels not allowed to insured institutions while at the same time paying nothing, risk-based or otherwise, for their guarantee.

3. The government requires thrifts, by the provisions of the Qualified Thrift Lender Test, to concentrate their investment activities in home mortgages while the advantages given to the agencies sponsored by the same government make it extremely difficult for thrifts to profitably operate in the market to which they have been assigned.

That almost two thousand thrifts made it through the extraordinarily difficult years of the 1980s in reasonably good shape would lead one to believe that they are virtually indestructible. However, the competitive inequities we face vis-a-vis the GSEs makes it very difficult for these institutions to earn a sufficient return to either build capital on their own or attract it from outside.

There is still a sliver of the mortgage market -- that for non-conforming loans -- where the agencies have not squeezed the profit margins (and it is interesting that some of the most healthy thrifts are located in the high-priced housing markets of California). Furthermore, as the RTC cleans up moribund thrifts, we hope to see the cost of our funds decreasing, thereby opening up our spreads somewhat.

Nonetheless, the jury is still out on how many of our institutions can continue to survive and prosper. It is obviously up to Congress to decide whether or not FNMA and FHLMC are to be the agents for delivering housing-finance services to the American people. **However, to the extent that unequal competition from these agencies is debilitating, or fatal in some cases, for private sector players in the mortgage market, the taxpayers' bill for resolving failed thrifts will be commensurately increased.** In short, the preferences given the GSEs are not only a problem for our institutions; they are also a potential ongoing problem for the taxpayer.

THE GOVERNMENT-SPONSORED HOUSING ENTERPRISES FINANCIAL SAFETY & SOUNDNESS ACT OF 1991

As we have tried to convey in the foregoing discussion, we look at Fannie Mae and Freddie Mac both as essential to housing finance and as highly privileged competitors. No one can deny that these firms have the best financial institution charter in existence today. Nor, can anyone deny that they serve an important purpose in residential finance.

Further, our experience with the debacle of the 1980s has shown us as an industry that we must always keep safety and soundness foremost in our minds. Capital, strong regulation and aggressive supervision are essential to the maintenance of our nation's financial institutions. We believe these concepts apply equally to Fannie Mae and Freddie Mac.

Of course, we recognize that these entities also have a special role in support of low- and moderate-income home buyers. We understand that a careful balance must be struck between serving these very important needs, safety and soundness, and competitive equity.

Unfortunately, we believe that this situation is currently significantly out of balance. Fannie Mae and Freddie Mac are no longer focused on low- and moderate-income households. Further, while the regulation, supervision, and capital requirements of all other financial institutions have increased substantially, Fannie Mae and Freddie Mac remain largely unaffected.

Once again, Mr. Chairman, we applaud the effort of this legislation to right this situation. We respectfully suggest, however, that more must be done. In this regard, we are most concerned about two major areas: affordable housing and capital.

AFFORDABLE HOUSING

As noted earlier, we believe Fannie Mae and Freddie Mac have a financial institution franchise which is the envy of everyone in the financial sector. This super franchise has allowed these firms to grow rapidly while making terrific profits.

In our view, the great success of these entities has not resulted from their efforts to aggressively serve low- and moderate-income borrowers as the Congress has mandated. Instead, they are progressively taking over the middle- and upper-income housing market which can be adequately served by the private sector.

For example, during the past six years, the agencies have increased their loan limits by 66% while the median selling price of existing homes has gone up only 26%.

In fact, the current loan limit of $191,250 now covers 80% of all U.S. households. At the upper end of the limit, borrowers must have an annual income of more than $82,000 to qualify for a loan.

Further, we are told that the implicit guarantee of the obligations of Fannie Mae and Freddie Mac create a benefit of between $2 billion and $4 billion a year. Still, only a part of this is shared with low- and moderate-income families.

Of course, the benefits of this agency guarantee also go to real estate investors and speculators. In addition, a large share goes to borrowers who are refinancing their mortgages in order to obtain funds for purposes other than housing. Of course, Fannie Mae and Freddie Mac stockholders have also benefited significantly from the existence of the federal government's guarantee.

In our view, the time has come for the Congress to better target Fannie Mae and Freddie Mac's lending. In this regard, Mr. Chairman, we strongly support your proposals that would require that a reasonable portion of Fannie Mae's and Freddie Mac's mortgage

purchases be related to the national goal of providing adequate housing for low- and moderate-income families. Further, we applaud the fact that you provide a specific definition for what constitutes low and moderate income.

We would urge you to go farther, however, and set some precise lending percentages. We would also suggest that that percentage be increased each year over the next four or five years.

Furthermore, where the proposal stipulates that these loans provide a "reasonable economic return" to the agencies we would suggest that this be interpreted to mean that the agencies are able to make a reasonable return on their total portfolio rather than on these loans in isolation.

Should one-third or one-half of these housing GSEs lending go to low- and moderate-income? We don't know the answer, but we believe it should be a substantial percentage.

We also want to strongly endorse your proposal, Mr. Chairman, to have Fannie Mae and Freddie Mac contribute to an affordable housing program. As proposed, this program would require that these entities set aside 20% of the dividends paid in the prior year. Currently, this could equate to about 4% or 5% of earnings. And since these contributions would be tax-deductible, the impact on the agencies would be commensurately reduced.

The Congress imposed a 5%-of-earnings program on the FHLBanks in FIRREA. However, the assessment in this case increases to 6% of earnings in 1994 and 10% in 1995. We believe a similar increase is warranted for Fannie Mae and Freddie Mac.

Once again, Mr. Chairman, we believe better targeting of Fannie Mae and Freddie Mac's lending activities is essential. We applaud your proposals in this regard and encourage you to strengthen them.

CAPITAL NEEDED

Among the many lessons to be learned from the thrift debacle, one stands out above all others: safety and soundness demands that financial institutions be adequately capitalized.

During the 1980s, Congress and the public learned that the combination of federal guarantees and low capital levels could lead to a disaster for the taxpayer. As a result, FIRREA mandated tough new capital standards, including risk-based standards, for thrift institutions. These new standards were essential if the taxpayer's future loss exposure was to be minimized.

In our view, it makes no sense to exempt Fannie Mae and Freddie Mac from these risk-based guidelines. What the risk-based guidelines tell us is that given the portfolio structure of these federal credit agencies, they are significantly undercapitalized.

For government-guaranteed entities, capital is widely and validly regarded as the buffer that protects the taxpaying public against potential losses. For commercial banks, and for thrifts in the past, the deposit insurance trust funds build up through insurance assessments represent a second wall of protection for taxpayers. (Unfortunately, even the combination of these two bulwarks proved an inadequate protection.)

With the GSEs, the trust fund reserves do not exist. If, in addition, their capital is also very low, then the concern that the taxpayer is highly exposed is a legitimate concern.

For the record, we would also note that thrifts and commercial banks pay billions of dollars in fees on their deposit insurance guarantees each year. Fannie Mae and Freddie Mac pay no fees for their guarantees.

Of course these companies and their constituencies argue that the rules for all other financial institutions should not apply to them. They have developed their own risk measures and deem themselves to be well-capitalized. Besides, they plan to increase their capital in the future.

These are the same kinds of arguments that were made by so many of today's failed thrifts in the past. Each had limited its risk exposure in all kinds of ways. Each was going to build its capital in the future. These arguments no longer are acceptable in the thrift industry and never should have been accepted by thrift regulators. They should not be acceptable for Fannie Mae and Freddie Mac.

Clearly, our arguments that competitive equity requires that the risk-based capital rules be applied to Fannie Mae and Freddie Mac have not garnered the support they deserve. As a result, we strongly endorsed the capital requirements proposed by the Treasury as a minimum.

Thus, we were greatly saddened to see the Treasury's minimal requirements further weakened in the proposals before the Subcommittee. We would urge you to strengthen these requirements now while Fannie Mae and Freddie Mac have easy access to the capital markets. Do not wait until it is too late as was the case for hundreds of thrifts.

Further, we would note that the proposed legislation gives the independent regulator exclusive authority to establish risk-based capital standards, but only against new products and programs to be offered by Fannie Mae and Freddie Mac. Since capital standards are the key to financial safety and soundness, we would urge you to give the independent regulator exclusive authority over all risk-based capital standards.

Finally, as far as capital is concerned, we would urge you to give careful consideration to the recent CBO study entitled, "Controlling the Risks of Government-Sponsored Enterprises." In that study, the CBO points out that there is a big difference in the capital requirements of the FHLBanks as compared to those of Fannie Mae and Freddie Mac.

They suggest, and we agree, that this situation puts the FHLBanks and the private sector firms that use them at a severe competitive disadvantage.

The CBO argues that if the capital standards for all housing GSEs were equalized it would represent "a step toward leveling the playing field in the housing finance system." We emphatically agree and urge you to correct the situation.

THE FEDERAL HOME LOAN BANK SYSTEM

Mr. Chairman, the thrift business cannot address the issue of the housing GSEs without also raising the topic of the FHLBank System. Obviously, the future of the FHLBanks is of vital concern to the thrift industry.

A hallmark of the FHLB System's past operations has been its stability. The System has the highest capital ratio of any government-sponsored enterprise. It has never experienced a loss.

The historic mission of the FHLB System has been to increase the availability of funds for mortgage finance. It has accomplished this goal in two ways:

1. It makes long-term loans, commonly called advances, to member institutions who provide mortgages to the homebuying public; and

2. It supplies a liquidity facility for residential mortgage lenders. This has allowed thrifts investing in mortgages to hold lower levels of liquidity than would otherwise be the case, making more funds available for mortgages.

With the passage of FIRREA, the FHLB System took on another mission which involved the operation of a new Affordable Housing Program (AHP). The System provides funds for this program and sees that they are used to help low income home buyers.

Of course, FIRREA did a lot more to the FHLB System than simply provide it with a new mission. It took the retained earnings of the FHLBanks to help pay for the FSLIC disaster. It also placed an annual assessment of $300 million on the System to help pay for REFCORP bonds.

In addition to these direct burdens, FIRREA had an indirect effect on the FHLB System as it impacted the System's member thrifts. FIRREA re-instituted meaningful capital requirements for thrifts. It also began the process of cleaning-up institutions that, though insolvent, had been operating for years. The combined effect of these much needed reforms was a significant shrinkage of the thrift industry.

The U.S. League of Savings Institutions has studied the future of the FHLB System, and has arrived at a series findings. I will limit the discussion here to actions that require legislative action.

ACTIONS NEEDED TO INSURE SAFETY & SOUNDNESS

In May 1989, the FHLB System had assets totaling $196.5 billion. Advances to member institutions amounted to $164.3 billion.

That turned out to be a high point for the System. Since then, it has undergone steady contraction. By May 1991, its total assets had fallen to $155.1 billion, a drop of 21% from the peak level. This decline was led by a sharp 40% fall in advances to members, from $164.3 billion to $98.7 billion.

This is not the first time the System has shrunk. Total advances declined in 1971, 1975, 1976 and 1983. These years coincided with the end of tight credit periods. As a countercyclical supplier of liquidity, a drop in advances at those turning points was to be expected.

The available evidence seems to suggest that the System will continue to operate in a shrinkage mode for a few more years. This means the dollar earnings of the System will also decline from current levels.

At the end of March 1991, the RTC reported that institutions under its control accounted for $9 billion in advances. According to the OTS, institutions slated for transfer to the RTC held another $11 billion in advances.

Once the RTC resolves its current and future case load, the Bank System will lose this $20 billion in lending business. Thus, RTC actions alone will likely reduce advances to around $87 billion, 19% below outstandings as of March 1991.

In the past, the System adjusted very well as the need for the funds it provided rose and declined in response to the economy. Earnings, dividends and stock holdings adjusted almost automatically to the changing demands on the System.

What has changed is that FIRREA created a flat dollar assessment on the FHLBanks for funding the Resolution Funding Corporation. Worse, this flat rate was based on the size of the System at its peak point in the 1980s.

As the System shrinks, its net income will decline. The problem for its member-owner savings institutions is that, regardless of how much the System contracts, it must still contribute $300 million a year to the REFCORP funding.

That this is a problem for member-owner savings institutions was recognized in a report by Moody's that reaffirmed the System's solid rating vis-a-vis its ability to service its consolidated obligations. To assuage the possible fears of those who lend funds to the Bank System, Moody's made the following two statements:

"The $300 million in yearly payments to Refcorp also constrain the FHLBanks' internal capital generation capacity. However, the brunt of these payments will probably be borne by shareholder/members in the form of lower dividends."

"Because FHLBank stock is carried on member/owners' balance sheets at par, any U.S. Government expropriation of FHLBank capital beyond their retained earnings would require members to write down their FHLBank stock, resulting in losses and weakening the capital of insured depository institutions, many of which are already in a precarious state. This provides FHLBank creditors additional capital protection."

All of this points to the need to change the flat rate charge against the Bank System's earnings to a percentage charge. This would stabilize the dividend yields paid by the System. It would relieve the pressure on the Bank System to grow or enter new business lines to increase dollar income, regardless of the return on equity of such ventures.

Without this change, the savings institution members are concerned that the Bank System policy will be driven by the need to boost dollar earnings (in order to meet these flat dollar charges and also pay a market rate of return on the stock investment), without regard to the risk-adjusted return of such new ventures.

In order for the System to generate a high return, it probably will have to engage in high-risk activities. Member savings institutions oppose the System's entry into any new business lines that would expose their stock investment to potential losses. For example, the savings institution business would be deeply troubled if the System began to make, purchase or securitize acquisition, construction and development loans.

This concern about the safety of the stock investment is especially justifiable for mandatory members, those that have no choice but to own a minimum amount of stock. In any other stock organization, if an owner feels that the corporation's activities might result in a depreciation or complete loss of the stock investment, the owner can sell the stock. This is not the case with the majority of the owners of the Bank System. As captive stockholders, mandatory members need protection for their own capital through a guarantee that the System will not engage in any activity that could force a partial or complete write-down of their stock investment.

FIRREA established a new regulator for the FHLB System -- the Federal Housing Finance Board -- to assume the functions of the former Federal Home Loan Bank Board vis-a-vis the FHLB System. The FHFB has the authority to supervise the FHLBanks and it must assure that the Federal Home Loan Banks are operated prudently to protect both the taxpayer and the capital investment of member institutions.

The System could also try to generate higher returns by competing directly with its members rather than through entering into high-risk ventures. In essence, the Bank System could use its GSE status to gain an advantage over its own members in offering various products and services.

The FHLBanks should concentrate on improving the quality and profitability of products and services that they currently offer. Its members should be encouraged to make use of such products and services. The FHLBanks should not engage in products and services that are in competition with their stockholders.

Does this doom the FHLB System to declining profits as it shrinks in the relatively near term? It does not. There is a very safe way the FHLB System can improve its earnings: by reducing its cost of operations.

As a whole, the System operates quite efficiently. The expense performance of individual Banks, however, varies widely. If all the Banks operated at the lowest cost currently exhibited by a Bank in the System, the System's net income would increase by roughly $80 million a year.

A more exhaustive analysis should be done to determine precisely how much money the System could save by having all the Banks operate at the same high level of efficiency. Options may include consolidation of Banks to take advantage of economies of scale and processing, or the consolidation under one Bank of a particular service currently offered by one or more Banks.

In the case of consolidating whole Banks, special attention would have to be given to merging the Banks on an equitable basis for existing members. For example, some Banks have a high level of funds in the dividend stabilization reserve (DSR) relative to their capital stock. The DSRs would have to be allocated on an equitable basis to a Bank's existing members before a merger could be effected.

This idea of consolidating Banks or functions will not be easy. Merger and cost cutting are never painless. But as has been demonstrated time and again in the banking and savings institutions businesses, it is a necessary step to ensure survival.

In sum, the current concern over the future of the Federal Home Loan Bank System is driven by the need to meet the flat dollar assessment imposed on it by FIRREA. This is what is behind the System's rush to enter new lines of business and ease the eligibility requirements for new members and borrowers. That is a poor way to conduct public policy, especially when what is being put at risk is a $10 billion investment held by mandatory members.

The member-owners of the System have two objectives. One is to preserve the value of the stock and the other is to see that the stock investment pays a market rate of return.

The member-owners are not seeking a higher dividend if the price is the System engaging in high-risk ventures or activities that compete with its members. Such risks could result in a write-down of the FHLBanks stock value.

By making the REFCORP levy a percentage of income and by having the FHLBanks concentrate on what they do best and reducing their operating costs, the stock investment of member-owners will be protected, the System will continue to pay a market dividend yield, and the REFCORP and the AHP will be guaranteed a regular flow of funds.

THE NEED FOR VOLUNTARY MEMBERSHIP

Language in FIRREA made membership in the FHLBanks possible for commercial banks and credit unions. Any commercial bank with 10% of its assets in the form of home mortgages and mortgage-backed securities is eligible for membership. As of December 31, 1990, 9,675 banks with $2.4 trillion in assets met this test. These banks accounted for 78% of the banking industry by number and 70% by assets.

If a bank elects to become a member, it must purchase stock equal to 1% of its home mortgage assets, with a minimum investment equal to 0.3% of assets. If it borrows from the System, it must purchase additional stock such that its total stock investment equals 5% of its advances divided by its "actual thrift investment percentage" as computed under the Qualified Thrift Lender test.

Some claim that these stock purchase requirements are too restrictive, making it uneconomical for commercial banks to borrow from the System. This is simply not the case.

In the first place, the home mortgage investment percentage that a bank needs to meet to be eligible for membership is not at all restrictive. After all, a savings institution member must maintain 70% of its assets in mortgage-related investments to have access to the System.

The very fact that over three-quarters of all banks are eligible for membership is testimony to the ease of entrance. In addition, since the Bank System does play a supporting role in the housing finance delivery system, it seems only logical that members display some constant and significant interest in housing.

Secondly, the additional stock purchase requirement for a borrowing commercial bank is not prohibitively large. That is, however, the perception.

That argument was, in fact, made by Federal Housing Finance Board Chairman Daniel Evans in his testimony before the House Banking Subcommittee on Housing and Community Development on May 29, 1991.

He stated:

"FHLBank System stock purchase requirements are significantly higher for commercial banks than thrifts. Thrifts must purchase a minimum level of FHLBank stock equal to 1% of their mortgage assets. Commercial banks, however, due to the makeup of their balance sheet, are often required to purchase a minimum level of stock equal to 0.3% of their total assets. Despite a potentially equal dollar commitment to housing finance, this requirement can far exceed the 1% of mortgage assets required of thrifts.

"For advance users, thrifts are required to purchase stock equal to 5% of their advances. In other words, they can leverage their investments by a ratio of 20:1. The minimum stock level for commercial bank borrowing is 5% divided by their mortgage investment percentage, which can reduce the leverage of commercial bank capital to as little as 2:1.

"Therefore, for a $100 million advance, a thrift is required to purchase $5 million of stock while a commercial bank may have to purchase as much as $50 million of stock.

"...[T]hese restrictions ignore the actual impact of a given financial institution on housing. A large commercial bank with 20% mortgage assets may well represent a greater dollar contribution to housing than some QTL lenders."

Technically, all that is correct, but note the use of terms like "can far exceed" and "can reduce" and "may have to" and "may well represent". Those qualifiers suggest that commercial banks are not always at a disadvantage in joining and borrowing from the FHLB System.

In reality, it is more likely the case that the thrifts are really the ones at the disadvantage. That is because thrifts, unlike banks, are mandatory members. Thrifts do not benefit from the advantages of voluntary membership.

Consider the example below. A bank and a thrift have an equal dollar commitment to mortgages of $300 million. Because the thrift must past the QTL test to be able to borrow from the FHLB System -- more on that point later -- the thrift's assets, assuming that it has 15% liquidity, must equal around $475 million. The bank's assets will be $1 billion, with 25% in liquidity.

To be a member, the bank will have to buy stock equal to the greater of 1% of home mortgage assets or 0.3% of total assets. In this case, that works out to $3,000,000. For the thrift, the requirement is 1% of its home mortgage investments, or $3,000,000.

Hence, the bank and the thrift, with the same dollar commitment to housing, will have to purchase the same $3,000,000 in stock. However, while for the bank that represents only

0.3% of assets, for the thrift that represents 0.63% of assets. **Thus, from this point of view, the thrift is at the disadvantage, not the bank.**

How does this requirement change if the institutions borrow from the FHLB System? The first point to note is that in order to borrow, the thrift must remain in compliance with the QTL test. If it fails the QTL test, even by a very small margin, it is completely denied access to advances. Hence, the thrift, regardless of its borrowing amount, must hold stock equal to 0.63% of its assets just to have the option to borrow advances. On the other hand, the bank can borrow as long as it maintains 10% of its assets in home mortgage investments and holds stock equal to at least 0.3% of its assets. It need not pass the QTL.

As depicted in the example, as long as the bank's advances do not equal a very large percentage of its mortgage assets, it will have a stock purchase requirement in dollar terms and relative to advances that is less than or, at worst, equal to that of the thrift.

In this example, as long as the advances do not exceed $20 million, or 6.7% of mortgage assets, the bank will actually have to purchase less stock than the thrift. That is because the thrift, as a mandatory member, must hold stock regardless of whether or not it borrows.

It is important to keep in mind that not many current members borrow advances equal to large percentages of their mortgage assets. The median ratio of advances-to-mortgage assets for healthy savings institutions is 6.7%. (It is just a coincidence that the median equals the breakpoint ratio in this example).

Furthermore, tangible evidence shows that many commercial banks that have joined the FHLB System do not view the 0.3% of assets stock purchase requirement as onerous. Of the 172 banks that had joined the System by early May 1991, 104, or 60%, had less than 30% of their assets invested in home mortgage investments.

Of the 15 banks with assets of more than $1 billion that joined the System, only four had a home mortgage-to-asset ratio in excess of 30%. Presumably, these large banks are rather sophisticated managers of their funds. It does not seem logical for them to make an uneconomical investment.

Many more banks have joined the System since early May. We have heard reports that the number is now over 250. Such growth again suggests that commercial bank membership requirements are not too tough.

We are not able to analyze the home mortgage investments of these banks because we cannot obtain an up-to-date list of commercial bank members of the FHLB System. It seems that some commercial banks have obtained from the FHFB an agreement that their membership in the FHLB System will be kept confidential for competitive purposes.

This policy of confidentiality greatly concerns us because it prevents studying how the housing investments of these commercial banks change once they become members of the System. Specifically, have they become more or less involved in housing?

The future dedication to housing by commercial bank members of the FHLB System should be closely monitored. If the FHLB System considers itself a wholesale bank for housing, it should ensure that its members remain active in that sector.

In any event, now that commercial banks (and credit unions) can become voluntary members of the Bank System on fairly liberal terms, it seems only equitable that consideration be given to making membership voluntary for all insured depository institutions. It is blatantly unfair that one set of institutions should have voluntary access and use of the System while being subsidized by the forced membership of another set of institutions.

Compulsory shareholders in the Federal Home Loan Banks have no particular leverage over the management of the Banks. How can these shareholders exercise discipline over the Banks' management if management knows that the shareholders are legally enjoined from selling their stock?

Membership in the FHLB System for SAIF-insured institutions should be voluntary, provided that the transition to voluntary membership is accomplished in an orderly manner that maintains the viability of the FHLB System and is equitable for existing members. The transition should be as rapid as possible, preferably within three years.

Until voluntary membership is completely achieved, a minimum number of seats on the boards of the district Banks should be reserved for mandatory SAIF-insured members. In addition, the eligibility, stock purchase and collateral requirements for potential members that do not demonstrate a dedication to housing should not be eased. Furthermore, membership in the FHLB System should not be expanded beyond federally insured depository institutions.

Also, the FHFB should be expanded to include at least one stockholder member from an individual member Bank. The individual should be a director of one of the district Banks and should be a mandatory member until voluntary membership is fully phased in.

The savings institutions business recognizes that a transition to voluntary membership cannot occur overnight. But the business fully believes that a vibrant System and voluntary membership are not mutually exclusive.

This fact is demonstrated by the Boston and New York Banks. The majority of the members of these Banks are voluntary. Their members are predominantly state-chartered, BIF-insured institutions. These two Banks are vibrant.

In short, there is no reason to expect, under a completely voluntary membership system, that mass stock redemptions by mandatory members. Their worries over the value of the stock could be mitigated by some of the proposals discussed earlier. In addition, unless institutions increase their internal levels of liquidity, they will want to maintain access to the System.

The Federal Home Loan Bank System, with its role in housing finance and as a provider of liquidity to members, remains a vital part of the structure of the savings institution business. In fact, given the current fragility of the financial system and the nervousness of depositors, its liquidity role for thrifts is probably more important than at any time since the 1930s.

The members of the Bank System also have a keen interest in maintaining the value of the huge amounts of capital they have invested in the FHLBanks' stock. They simply cannot afford to take a hit to their capital positions if that investment is impaired, whether through further confiscation of the Banks' capital to pay for the cleanup of failed financial institutions or through losses charged to the Federal Home Loan Banks' capital account because of unwise investments by the Banks. (The taxpayers' interests are also at stake here. The FHLBanks' high capital position directly protects the taxpayer against losses in the Banks but any impairment of that capital could be costly to the taxpayer because of the harmful effect on federally-insured member institutions.)

All of this suggests that the future of the Federal Home Loan Banks is a vital interest of the savings institution business. As long as thrifts are required to be major investors in the FHLB System, they should, as member-owners, play a key role in determining its future.

WHY BANKS ARE NOT ALWAYS AT A DISADVANTAGE WHEN JOINING THE FHLB SYSTEM

	Bank	Thrift
Total Assets	$1,000,000,000	$475,000,000
Mortgage assets	$300,000,000	$300,000,000
Mortgage assets to assets	30.0%	63.2%
FHLB Stock purchase requirement	$3,000,000	$3,000,000
As a % of assets	0.30%	0.63%
Liquidity	$250,000,000	$71,250,000
Actual thrift investment percentage	33.3%	70.2%
High borrowings: Bank purchases more stock than thrift; bank has lower leverage ratio		
Borrowings	$100,000,000	$100,000,000
As a % of mortgage assets	33.3%	33.3%
Stock required	$15,000,000	$5,000,000
As a % of assets	1.5%	1.1%
Leverage ratio	6.7	20.0
Moderate borrowings: Bank purchases same stock as thrift; leverage ratios are the same		
Borrowings	$20,000,000	$20,000,000
As a % of mortgage assets	6.7%	6.7%
Stock required	$3,000,000	$3,000,000
As a % of assets	0.30%	0.63%
Leverage ratio	6.7	6.7

Testimony
Submitted by

George Butts
President
ACORN Housing Corporation
Philadelphia, PA

On

Community Reinvestment Lending and Reform of
Secondary Mortgage Market Agencies

to

Subcommittee on Housing and Community
Development
Committee on Banking, Housing, and Urban Affairs
U.S. House of Representatives

The Honorable Henry B. Gonzalez
Chairman

July 19, 1991

Mr. Chairman, Members of the Subcommittee I am George Butts, President of the ACORN Housing Corporation of Philadelphia, PA. I am here today representing the 80,000 nationwide low- and moderate-income members of ACORN, the Association of Community Organizations for Reform Now. ACORN has neighborhood chapters in 26 states and has successfully negotiated over 25 Community Reinvestment Act bank agreements representing more than $500 million in targeted loan commitments for low-income homeownership.

ACORN is pleased to present testimony today on the role of the secondary mortgage market in community reinvestment lending and to comment on pending legislation establishing affordable housing guidelines, capital standards and a regulatory structure for the secondary mortgage market agencies of Fannie Mae and Freddie Mac. For far too long far too little attention has been paid to the influence of the secondary mortgage market on the availability and the lack of availability of mortgage credit in low- and moderate-income neighborhoods.

We commend the Chairman and this Subcommittee for their leadership in inaugurating today what we hope will be an extended exploration of secondary mortgage market activity in low-income neighborhoods.

For well over a decade, ACORN --the country's largest grassroots organization of low- and moderate-income people-- has been at the forefront of community-based efforts to ensure that low- and moderate-income neighborhoods obtain life sustaining credit from private federally chartered banks and savings and loan associations.

I would like to begin by reminding this Committee that low -income homeownership is not some far off dream. It is a reality if the necessary pieces are in put into place by community leaders, local lenders and, yes, the secondary mortgage market. It may sometimes be difficult to achieve, particularly in many high-cost residential markets, but, when aspiring homeowners, dedicated community organizers and local lenders do the necessary work, the doors of homeownership need not be barred from low- and moderate-income families.

ACORN has spearheaded a real bank and community partnership in recent years in Philadelphia, St. Louis, Chicago, Des Moines and Minneapolis/St. Paul to name just a few cities. These partnerships combine aggressive lending by banks and creative marketing and pre-purchase counseling by community groups to produce targeted loan programs that are meeting underserved credit needs in low-income communities. All of this has been done without any tax subsidy. Community groups like ACORN have figured out how to make lending safe and profitable in low -income comunities. The continued success of these partnerships is dependent on resolving unnecessary hurdles that the secondary

mortgage market places on community reinvestment lending.

Mr. Chairman, on behalf of ACORN, I wish to extend our warmest thanks for your leadership in the recent fight to preserve the CRA. I am troubled, however, to report to you that while CRA is alive in the statute, it is being strangled at the grassroots by the daily business practices of Fannie Mae and Freddie Mac. Merely preserving the status quo with respect to CRA demands a real overhaul of these publically-chartered and -subsidized institutions.

SUMMARY OF RECOMMENDATIONS

In order to ensure that community lending is a viable option for local financial institutions in the 1990's and into the next century, ACORN recommends that legislation be passed to ensure that secondary mortgage market agencies:

1) affirmatively support low-income homeownership and affordable multi-family rental housing by setting aside a certain annual amount of their taxpayer subsidized profits to support mortgage provision to low-income households.

2) devote no less than 30% of their annual mortgage purchases to loans from families at or below 80% of Area Median Income of which half should be purchases of mortgages from families at or below 60% of Area Median Income.

3) establish firm anti-discrimination policy, and require Fannie Mae and Freddie Mac to terminate business with known discriminatory lenders. And,

4) publically disclose race, gender, income level and location of their purchased, securitized and held mortgages by requiring agency reporting under the Home Mortgage Disclosure Act (HMDA).

PUBLIC BENEFITS AND OBLIGATIONS OF FANNIE MAE AND FREDDIE MAC

American taxpayers have bestowed upon the secondary mortgage market agencies a long list of financial privilages that underwrite the ability of these agencies to compete in the financial marketplace and deliver a handsome return to their shareholders. In return for these benefits, the agencies have public charter obligations to support the provision of mortgage credit in the economy by facilitating private capital investment in home mortgages and mortgage related assets. This charter obligation specifically cites Fannie Mae and Freddie Mac's ongoing reponsibility to facilitate investment in "mortgages securing housing for low- and moderate-income families."

The two agencies have achieved a dominant position in the conventional secondary mortgage market in substantial part because of the special benefits of taxpayer assistance. In fact,

the recent Congressional Budget Office (CBO) report Controlling the Risks of Government-Sponsored Enterprises states that Fannie Mae and Freddie Mac's "significant market power arises from the implicit federal subsidies they receive," including: Treasury Department authority to purchase their debt; exemption from Securities and Exchange Commission (SEC) regulation; Federal Reserve ability to buy agency issued securities; collateral qualification for Federal Reserve advances; exemption from state and local corporate taxation; and the implied backing of the taxpayer standing behind agency debt and each and every agency issued mortgage-backed security.

These legal benefits give Fannie Mae and Freddie Mac substantial financial advantages in the marketplace. The implicit federal guarantee of agency obligations leads financial investors in agency debt or mortgage-backed securities to believe that the taxpayer stands behind the risk of agency activities. As a result of this taxpayer provided insulation from the market, Fannie Mae and Freddie Mac's securities trade at preferential rates and they are able to borrow from the capital markets at significant advantage over all other private and public borrowers with the exception of the U.S. Treasury.

The CBO estimates that the taxpayer subisidy amounts to a borrowing advantage of 30 basis points on agency debt and securities. On the basis of the CBO figure, some estimate that this translates into an annual $4 billion taxpayer subsidy to Fannie Mae and Freddie Mac.

In a fiscal climate of scarce resources, ACORN wonders how is this public subsidy targeted? Are these taxpayer subsidies targeted to those most in need of federal assistance in the mortgage market? Are unjustified subsidies being wasted on households that do not need public assistance? Are the taxpayers, particularly the low- and moderate-income taxpayers, getting their fair return for Fannie Mae and Freddie Mac's public dole? These are critical public policy questions that this Congress cannot avoid.

FANNIE MAE AND FREDDIE MAC'S IMPACT ON THE MORTGAGE MARKET

In our experience with dozens of local lenders over many years it has been clear and is increasingly clear that the secondary mortgage market has been a hidden officer at the loan origination table. Although physically absent, the hand of the secondary market has been felt as we have tried to negotiate loan products with lender after lender that was willing and able to accomodate the economic realities of low-income households and low-income neighborhoods.

Tragically, the impact of the secondary market in low -income communities has often been the rejection stamp of a local loan officer who is simply following bank credit policy that was developed not by a local bank to meet the

characteristics of a particular credit worthy borrower but to meet the dictates of a far away and absent secondary market corporation. Many times over the last decade, ACORN members have seen their hard work with local bankers wither away as willing lenders tell us: "Sorry, we would like to offer the loans you need but we cannot sell them."

It is a rare lender that is not concerned about whether or not the mortgage loans they make can or cannot be sold to the secondary market. In the course of the last decade, local lenders have become increasingly reliant on the secondary market to buy locally originated loans. We are no longer in the "It's A Wonderful Life" day of portfolio lending. The securitization of mortgage assets is standard business today and, due to various market and regulatory forces, including new risk-based capital standards, will only increase in the future.

Fannie Mae and Freddie Mac's influence on the mortgage market is therefore profound. According to the CBO, in the eight year period from 1981 to 1989, Fannie Mae and Freddie Mac's share of newly originated Fixed Rate Mortgages skyrocketed from 4 percent to near dominance at 69 percent.

The standards that the secondary mortgage market employ are therefore, the driving force in mortgage products offered at financial institutions. Fannie Mae and Freddie Mac have a truly determinative effect on today's mortgage market. Or, as the GAO noted in last year's Secondary Mortgage Market: Information on Underwriting and Home Loans in the Atlanta Area: "Underwriting standards indirectly establish the qualifications that loans to individual borrowers must meet to be eligible for delivery to the secondary mortgage market." We know this well from our work with local lenders and this is clearly evident in the dramatic market share of the secondary market agencies in today's mortgage marketplace. The influence of the secondary market agencies is so profound that local bankers, mortgage companies and even state housing finance agencies fear corporate retribution if they bring to the negotiating table their own or community complaints of agency inflexibility.

Unfortunately, the standardization of mortgage products that the secondary market has brought upon home finance has placed new hurdles and obstacles to low-income families who seek mortgage credit from local lenders. While standardization of mortgage products may make business easier for multi-billion dollar corporations like Fannie Mae and Freddie Mac, it clearly imposes real barriers to mortgage credit for applicants who do not fit the latest cookie-cutter fashion cooked up by secondary market underwriters.

In fact, the recently released report to the President on regulatory barriers to affordable housing, Not In My Back Yard, underscores the negative impact that secondary mortgage market standards have on community lending:

"Fannie Mae's and Freddie Mac's underwriting standards are oriented towards "plain vanilla" mortgages. The standards encourage lending in suburban, growing, homogenous, and higher income areas, where housing and zoning requirements result in the production of "cookie cutter" new homes in uniformly single-family neighborhoods. These standards work against more diverse building types and mixed-use neighborhoods, which are more difficult to assess and to underwrite."

As this Committee is well aware, the authors of this report are hardly from the ranks of our nation's community activists. Many of the members of the Advisory Commission on Regulatory Barriers to Affordable Housing are from the conservative wing of the public and private sectors.

It is ACORN's observation that the underwriting criteria employed by Fannie Mae and Freddie Mac have been developed not for the general mortgage market, which includes low- and moderate-income homeowners, but for a middle-income and substantially suburban mortgage market. As a result, it is our firm belief that the underwriting standards dictated by the secondary mortgage market are, at a minimum, income discriminatory and may, by extension, be racially discriminatory. The Advisory Commission's report comes to the same conclusion: "Fannie Mae and Freddie Mac have had anti-discrimination and anti-redlining guidelines, but have not consistently followed them."

Clearly, then, Fannie Mae and Freddie Mac are not benign players in the origination of home mortgage loans. In fact, while Fannie Mae and Freddie Mac may be putting middle- and upper-middle income families into suburban homes and returning handsome dividends to their stockholders, they may equally be a real contributor to housing affordability and availability crunches for millions of low- and moderate-income Americans.

In order to show evidence of this condition I would like to briefly detail for the Committee how CRA type-lending has developed and outline the features of lending arrangements that ACORN has developed with local lenders to meet the credit needs of low- income communities.

THE SUCCESS OF CRA LENDING

With the passage of the Community Reinvestment Act in 1977, low-income people and community organizations acquired an important tool to work with local lenders in the provision of credit to low- income communities. For thousands of ACORN members and their millions of low-income neighbors, the CRA is an invaluable resource for helping financial institutions provide basic financial services to our nation's low-income communities.

Despite the CRA's troubled regulatory status, of which this Committee is well aware, community groups like ACORN have used the CRA to negotiate many sound lending agreements with banks to meet low-income community credit needs.

The dozens of lending programs that ACORN has developed and implemented through the CRA with local lenders have four basic features:

1) They all employ non-standard underwriting that is sensitive to the economic realities of low-income households and communities.

2) They generally involve a pre- and post-homeownership counseling component.

3) The mortgage product is often at a below-market rate.

4) A land trust model of ownership is often built into the mortgage to ensure long-term affordability for low-income households.

Although not all of these features are necessary to ensure an affordable mortgage product for every low-income family, each is a critical part of the CRA-type lending that ACORN has developed with local banks and savings and loans. In many real estate markets, affordable loans can only be delivered to low - and moderate-income borrowers with all of these features in place.

The performance of the lending programs ACORN has developed through the CRA have posed no greater risk to lenders than their standard home mortgage lending operations. In many cases, ACORN lending programs have performed better in terms of default rate than non-CRA loan activity with the banks we have worked with.

Despite the willingness of local lenders to make these types of loans and the seasoned status of many of these CRA loan portfolios, we have increasingly been told by our bankers that the characteristics of these loans are not acceptable the secondary market. In fact, <u>many of lenders we work with who now hold multi-million dollar CRA portfolios have told us that they may soon be unable to originate more of these loans if they remain unable to sell them to Fannie Mae or Freddie Mac.</u>

<u>UNDERWRITING CRITERIA AND CRA LOANS</u>

I would like to outline in greater detail the underwriting that ACORN has developed with CRA lenders and identify where these underwriting guidelines have run up against underwriting employed by the secondary market. Many of the rules discriminate against low-income borrowers. These criteria bear little relation to the facts about who pays their bills and who pays them on time. CRA lending is generally not high risk

lending for the bank.

Downpayments

Credit worthy low-income applicants do not, by definition, have the degree of savings available to more affluent mortgage borrowers. However, this need not bar them from homeownership opportunities.

Our CRA lending programs generally employ no more than 5% downpayment requirements for a borrower, with many programs set at 3%.

Tragically, Fannie Mae and Freddie Mac have slashed their purchase of low downpayment loans over the last half-decade. Since 1985, as the attached table shows (Appendix A), both agencies have virtually cut in half their investment in fixed -rate, low downpayment loans. Such loans service America's marginal and most needy would-be homeowners.

The additional table (Appendix B), drawn from the national data base of the private mortgage insurers, demonstrates that lower balance loans, which as a rule are originated to low -income borrowers, are generally less risky than higher balance loans. This PMI data shows that the risk of default increases with loan balance size and suggests that low-income borrowers actually pose a reduced risk to lenders, private mortgage insurance companies and the secondary mortgage market agencies. Fannie Mae and Freddie Mac may have abandoned not only America's marginal homeowner, but also a secure and low risk market.

While it is true that 5% downpayment requirements are occassionally acceptable to the secondary market, there are serious underwriting obstacles in the required downpayment source. Both Fannie Mae and Freddie Mac do not permit cash-on -hand to be a source for downpayments. "Mattress money," as cash -on-hand is more commonly know, is a commonplace in low-income communities which lack general access to banking services commonly available in higher income neighborhoods. Fully one out of every five loans in our combined Philadelphia lending program, involves a cash-on-hand downpayment. The banks with which we have working relationships recognize that not every credit worthy applicant need possess a bank account to get a loan.

Sweat-equity contributions

In our programs, sweat-equity contributions by a loan applicant that increase the value of a property can be considered a cash investment for purposes of calculating loan-to -value ratios. It is our understanding that Fannie Mae and Freddie Mac are averse to counting sweat-equity as a source of cash investment, despite the fact that sweat-equity is commonly

employed in the delivery of affordable housing.

Debt-to-income ratios

Almost without exception, our CRA programs incorporate debt -to-income ratios that are generally unacceptable or reluctantly acceptable to the secondary market. In our programs the ratio of housing payment and total debt to gross monthly income is generally 33% and 38%, respectively. In fact, our banks permit higher DTI ratios if the applicant is currently making housing payments with higher ratios, provided there is a good credit history.

Income Source

Some sources of income for low-income people are ignored by Fannie and Freddie. Food stamps, child support --even when it is not court ordered-- and unemployment insurance are valid income sources which Fannie and Freddie should accept. Documented but unreported income is also accepted by many of our banks.

These later sources of income have been reported to us by our lenders to be unacceptable to the secondary market.

Income Continuity

Standard mortgage underwriting assesses the likelihood of a stable source of income on the basis of job continuity. Reliance on job continuity alone is not, however, an adequate measure of income stability in low-income communities. The low -income economy is much more fluid than that of higher income sectors of our general economy. Job tenure is often much shorter due to the seasonal nature of many occupations held by low -income people and the general lack of opportunities for career advancement.

The standard industry rule has been two years at the same job for a mortgage applicant. However, a loan we recently originated with a St. Louis lender was recently rejected by Fannie Mae on the grounds that the borrower had a "career change." The borrower had moved from an auto assembly line occupation to that of electronic assembly. Her new electronics job actually paid more than her old auto assembly job.

In our programs, loan applicants must demonstrate an ability to maintain a base level of income over two years, regardless of the variety of employers or sources of income. The important criteria is not job continuity, but income continuity.

Credit History

Middle-income markers of credit history are often unavailable in low-income communities. Consumer credit records are often unavailable because low-income people are denied access to such credit.

Our agreements with local lenders permit applicants with credit history marked by late payments and/or judgements to not be disqualified if they can demonstrate a pattern of good faith efforts to catch up and if they can clearly demonstrate that delinquencies are due to circumstances beyond their control, such as illness, divorce or layoffs. Furthermore, a qualified borrower with a satisfactory payment record within the previous twelve months prior to the submission of a loan application will not be disqualified due to an earlier blemish in their credit record.

We are currently trying to work out the details of a homeownership loan program with the Resolution Trust Corporation. These negotiations are at a standstill today because the secondary market player involved, Freddie Mac, is unwilling to accept credit history guidelines like those above.

<u>OTHER IMPACTS OF THE SECONDARY MARKET ON CRA LENDING</u>

The following four additional features of our loan programs have presented obstacles for our lenders in trying to sell loans to the secondary market.

1) Neighborhood Factors

Much of our loan activity is in inner-city neighborhoods where housing abandonment is widespread. Lenders have cited Fannie and Freddie standards as reasons for loan denials when applicants have sought mortgages on blocks with vacancies greater than 10 or 15 percent. In cities like Philadelphia, where there are 21,000 vacant houses, these vacancy rates are common and yet there is still an active real estate market. The number of vacant houses should never be a reason for turning down a loan. <u>Individual appraisals</u> of secured property protect banks and Fannie Mae and Freddie Mac from default claims that may exceed the actual worth of an individual property.

Yet, Fannie Mae's underwriting guidelines provide for a "neighborhood rating system" for appraisors to assess not property to property values but neighborhood to neighborhood characteristics and features. The use of these "locational factors" unduly burdens mortgage applicants who choose to buy secured property in neighborhoods that may not be picture perfect. In fact, Fannie Mae's guidelines discourage lenders from providing "maximum financing" to borrowers who seek loans for appraised properties in neighborhoods that have low growth rates, high vacancy rates or older structures.

2) Purchase-Rehabilitation Financing

Most of the housing stock in low-income communities is not new. There are many houses in inner-city neighborhoods that require rehabilitation. The inability of lenders to find secondary market buyers for purchase/rehabilitation financing --financing that provides funds for both the aquisition of a home and necessary repairs-- is often the source of many loan rejections for otherwise creditworthy projects.

3) Land Trusts

ACORN routinely employs a land trust form of homeownership to ensure that housing is affordable to as low an income group as is possible. This model of ownership places the land beneath a house in a common trust while the actual home is owned by the lower income family. The financing of these properties has involved the subordination of the trust deed to the banks first mortgage to the homeowner.

We have had great difficulty in getting Freddie Mac to consider loans with these types of deed structures.

4) Below-market loans

As stated above, most of our loan programs involve below market loan pricing. The banks we work with realize that this is absolutely necessary in order to do business in low-income communities. Profit yes. But, high margins are not likely.

To our knowledge both Fannie Mae and Freddie Mac are absolutely unwilling to consider buying any loan that is not at market rate.

RECOMMENDATIONS AND COMMENTS ON H.R. 2900

ACORN does not believe that Fannie Mae and Freddie Mac are doing enough to help private lenders meet the demand for credit in low-income communities. It would be tragic if these Government Sponsored Enterprises continue to turn their backs on low-income neighborhoods and individuals that private banks are, with far fewer resources than Fannie Mae or Freddie Mac, able to help.

Clearly, Mr. Chairman many policy concerns result from the standardization of mortgage products that Fannie Mae and Freddie Mac have imposed on mortgage markets. We are glad to see that H.R. 2900 takes some steps to address these longstanding problems.

• We support the development of an affordable housing program at Fannie Mae and Freddie Mac and would support the proposal in H.R. 2900 with revision.

ACORN believes that a public obligation to support affordable housing development does not stem from the thickness of the wallets of agency stockholders. The welfare of agency stockholders should not be the criteria for the depth of a public obligation. There should be a known floor to any support for affordable housing.

In contrast to the H.R. 2900 proposal to peg contributions to affordable housing to annual dividend payments, ACORN proposes that Fannie Mae and Freddie Mac be required to set aside a portion of their annual profits to expande homeownership opportunities for low-income households. Under your leadership Mr. Chairman, the Congress established this form of assurance of community service in FIRREA with respect to the Federal Home Loan Banks, another GSE. If this is good public policy for other GSE's, like the Federal Home Loan Banks, it is prudent public policy for secondary market GSEs. Dividends are often capricious, and Fannie and Freddie's dividend payouts will be uncertain over the next several years. As this Committee is well aware, viable affordable housing programs require the certainty of funding.

Additionally, we suggest that an Affordable Housing Program be established at Fannie Mae and Freddie Mac for both single-family and multi-family affordable housing development. And, any effective affordable housing program at Fannie Mae and Freddie Mac must provide resources for agency purchase of below-market loans at par and agency assistance to lender origination of below-market loans to single-family and multi-family borrowers. This will ensure the continued vibrancy and effectiveness of CRA lending throughout the country.

We would propose that funding levels for Fannie Mae and Freddie Mac be equivalent to those established in the FIRREA legislation for the Federal Home Loan Banks. As the GAO notes in its recent report Government Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks, these funding levels do not pose a financial burden on the Home Loan Banks and "ensure that these programmatic activities do not threaten the financial soundness of the firms."

If these proposed funding levels were in place last year at Fannie Mae and Freddie Mac the rate of return to shareholders would have only been marginally reduced. Last year, Fannie Mae realized a $1.2 billion profit, equivalent to a 34% return on equity. Freddie Mac realized a profit of $414 million in 1990, equivalent to a 20% return on equity. Had our proposal been in place, the return on equity for Fannie Mae would have been 32%, and the return on equity for Freddie Mac would have been 18% --both well above average returns in the private sector.

• Require that Fannie Mae and Freddie Mac purchase low-income mortgages to ensure reform of discriminatory underwriting standards. No less than 30% of annual agency

mortgage purchases should be from borrowers at less than 80% of Area Median Income of which no less than half are from borrowers whose income does not exceed 60% of Area Median Income.

Existing HUD regulations --and years of discussion between banks, community organizations and the agencies-- have failed to achieve the goal established in agency charters for secondary mortgage market support of low-income homeownership and affordable rental housing.

• Establish anti-discriminatory policy for Fannie Mae and Freddie Mac. These agencies should be barred from purchasing loans from any known lender that discriminates on the basis of race or gender.

In a recent study commissioned by Freddie Mac, researchers found that "mortgage originations and loan acceptance rates uncovered systematic differences between minority and non -minority neighborhoods." While both agencies have elaborate guidelines for disciplining lenders that operate in a financially unsound manner, they apparently have no policy whatsoever for dealing with lenders that have demonstrated a pattern and practice of discrimination and redlining. Compliance with the Community Reinvestment Act, the Equal Credit Opportunity Act, and the Fair Housing Act should be the minimal standard for access to the government-supported secondary market.

• Place Fannie Mae and Freddie Mac under the reporting requirements of the Home Mortgage Disclosure Act (HMDA). As taxpayer supported entities, Fannie Mae and Freddie Mac have no less of an obligation to report on their loan portfolios than federally chartered depositories.

CONCLUSION

Over the last few years a new generation of community lending financial institutions have risen to meet the dire needs for mortgage credit in low-income communities. These banks are doing good work. They are carrying out responsibilities that come with their charters to meet the credit needs of their entire community, not just the community of borrowers that is easiest to serve. These lenders are doing the hard work that is required to create homeownership opportunities for low-income families. Without the assistance of the federal government, these lenders are helping to rebuild low-income neighborhoods.

It is ironic that Fannie Mae and Freddie Mac, Government Sponsored Enterprises who receive substantial benefit from their implicit taxpayer backing through the U.S. Treasury, are not be partners in this desperately needed lending activity. A casual reader of the business papers will readily note that the

secondary market entities are making a whole lot of money. We can assure you that they are not making it in our neighborhoods.

Thank you Mr. Chairman, that concludes my testimony.

APPENDIX A

Source: Congressional Budget Office: "Controlling the Risks of Government-Sponsored Enterprises," April, 1991; p. 146.

TABLE 16. FANNIE MAE AND FREDDIE MAC's CONVENTIONAL SINGLE-FAMILY MORTGAGE PURCHASES AND MBS ISSUES, 1985-1990, BY LOAN-TO-VALUE (LTV) RATIO (In percent)

LTV Ratio	1985	1986	1987	1988	1989	1990	Outstanding as of 12/31/90
Fannie Mae							
Purchases for Portfolio							
Fixed-Rate Mortgages							
Not available	0	0	0	0	0	1	1
0 to 80	78	85	85	82	83	80	75
81 to 90	13	12	11	14	14	14	15
91 to 100	8	4	4	4	3	5	9
Adjustable-Rate Mortgages							
Not available	0	0	0	0	0	0	1
0 to 80	40	61	67	65	69	80	61
81 to 90	24	30	30	32	30	18	26
91 to 100	36	9	3	2	1	2	12
Mortgage-Backed Securities Issued							
Fixed-Rate Mortgages							
Not available	0	0	0	0	0	0	a
0 to 80	72	79	79	77	78	77	77
81 to 90	14	15	16	17	16	16	16
91 to 100	13	6	5	6	6	7	6
Adjustable-Rate Mortgages							
Not available	0	0	0	0	0	0	0
0 to 80	84	85	84	66	74	76	74
81 to 90	14	13	15	32	24	20	24
91 to 100	1	2	1	2	2	4	2
Freddie Mac (All Purchases)							
Fixed-Rate Mortgages							
Not available	0	0	0	0	0	0	0
0 to 80	76	81	82	80	79	83	80
81 to 90	15	14	14	14	15	13	15
91 to 100	8	6	5	5	4	4	5
Adjustable-Rate Morgages							
Not available	0	0	0	0	0	0	0
0 to 80	55	63	61	66	70	70	69
81 to 90	23	26	28	24	22	21	22
91 to 100	22	10	11	10	7	9	9

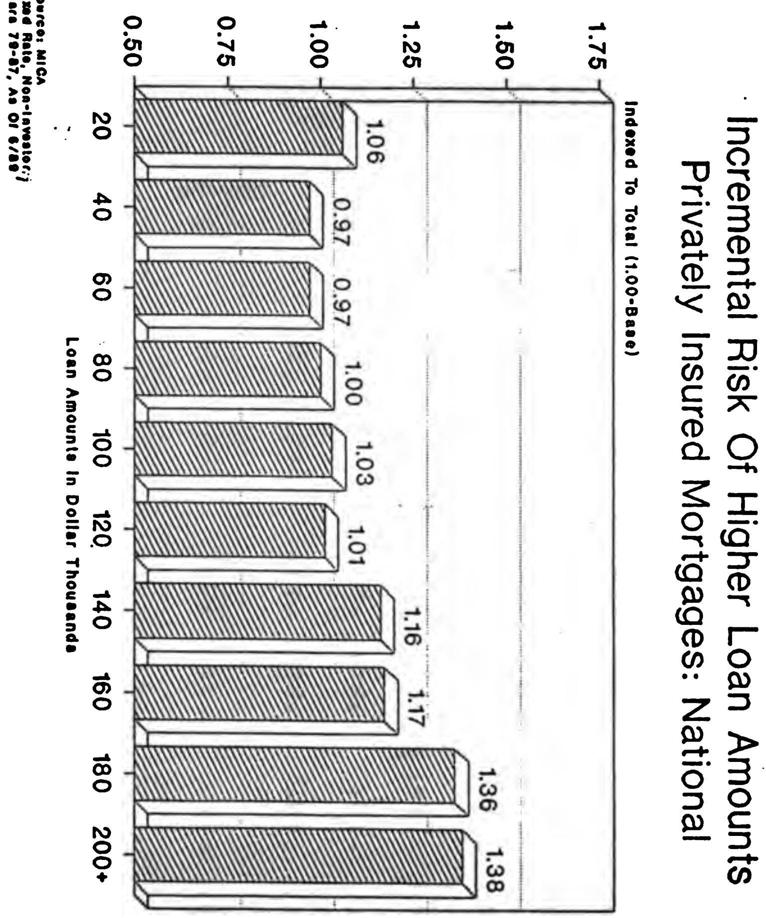
SOURCE: Congressional Budget Office using data from Fannie Mae and Freddie Mac.

NOTE: For Fannie Mae, LTV ratios are at the time of loan origination. For Freddie Mac, LTV ratios are at the time of purchase by the GSE.

a. Less than 0.5 percent.

APPENDIX B

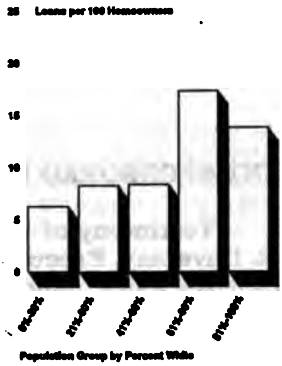
Source: Mortgage Insurance Corporation of America (MICA) data for Fixed-Rate, Non-Investor Loans from 1979-1987.



APPENDIX C

Source: GAO Report, "Secondary Mortgage Market: Information on Underwriting and Home Loans in the Atlanta Area," November, 1990; pp. 37-38

Figure III.3: Number of Loans per 100 Homeowners by Population Group



Source: Loan data provided by Fannie Mae, Freddie Mac, and HUD. Demographic data provided by DMIS and the 1980 Census.

Loan Activity by Population Group

When considering the secondary market loan activity in relation to only one variable—the racial composition of the ZIP code areas, the data show that such activity was greater in predominately white (61-100 percent white) ZIP code areas. The average and median loan amounts and home prices also increased as the percentage of white population increased in a ZIP code area.

For the 80 ZIP code areas in the five metropolitan Atlanta counties, the number of loans per 100 homeowners was higher in the predominately white ZIP code areas than in the predominately minority or integrated ZIP code areas. (See fig. III.3.) The number of loans per 100 homeowners ranged from 6.2 in the predominately minority (0-20 percent white) ZIP code areas to 8.3 in the relatively integrated (41-60 percent white/minority) ZIP code areas. However, the 61-80 percent white ZIP code areas received 17.2 loans per 100 homeowners, and the 81-100 percent white ZIP code areas received 13.7 loans per 100 homeowners.

GOVERNMENT-SPONSORED ENTERPRISES

Testimony of
Terrence R. Duvernay, Executive Director,
Georgia Housing and Finance Authority

on Behalf of the
National Council of State Housing Agencies

Before the
House Committee on Banking, Finance and Urban Affairs
Subcommittee on Housing and Community Development

July 19, 1991

Testimony of Terrence R. Duvernay, Executive Director,
Georgia Housing and Finance Authority
on Behalf of the
National Council of State Housing Agencies
Before the
House Committee on Banking, Finance and Urban Affairs
Subcommittee on Housing and Community Development

July 19, 1991

Chairman Gonzalez, Representative Roukema and members of the Subcommittee, my name is Terrence Duvernay. I am Executive Director of the Georgia Housing and Finance Authority (GHFA). I also serve as President of the National Council of State Housing Agencies (NCSHA), on whose behalf I am testifying this morning.

Within NCSHA, I chair a Task Force of State Housing Finance Agency (HFA) representatives which NCSHA has organized to meet regularly with the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) to discuss making their programs more relevant to low income people.

We appreciate this opportunity to testify on your legislation (H.R. 2900) to improve the financial safety and soundness of FNMA and FHLMC, particularly with regard to its proposed Affordable Housing Program (AHP). We commend you for recognizing that these important institutions can and should do more to provide affordable housing for low income Americans.

NCSHA is a national, not-for-profit organization created in 1970 to represent the interests of HFAs in low and moderate income housing. HFAs in every state, the District of Columbia, Puerto Rico, and the Virgin Islands respond to low and moderate income housing needs through the financing, development, and preservation of affordable ownership and rental housing. HFAs collectively operate over 600 affordable housing programs, which range from homeownership to homeless initiatives.

HFAs have helped more than 1.3 million lower income families buy their first home through Mortgage Revenue Bond (MRB) programs which they administer in almost every state. They have also financed over 500,000 units of rental housing for low and moderate income tenants through reduced interest rate mortgages financed by tax-exempt bonds. In addition, since 1986, HFAs have helped finance 316,128 low income rental units with the Low Income Housing Tax Credit (Tax Credit) for households with incomes at 60 percent or less of area median. I want to take this opportunity to thank you, Mr. Chairman and Representative Roukema, and the many members of this

Subcommittee who have cosponsored legislation in this Congress to make the MRB and Tax Credit programs permanent.

Congress has entrusted FNMA and FHLMC with the responsibility to assure the availability of mortgage capital to low and moderate income families. Measures to ensure FNMA's and FHLMC's safety and soundness need not be inconsistent with that Congressionally-mandated public purpose. We believe the proposed AHP, coupled with FNMA's and FHLMC's existing or contemplated affordable housing efforts, would go a long way toward meeting their affordable housing mandate, even as they strengthen their capital position.

We applaud FNMA for all that they have done in affordable housing. Their efforts have gone beyond the minimum required of them by regulation. We also commend FHLMC for hiring Carl Riedy, the former executive director of NCSHA and someone of great talent and vision in affordable housing finance, to build an affordable housing program within FHLMC which is responsive to its identical mandate. We urge the Subcommittee to explicitly require FNMA to continue and expand its current level of effort in affordable housing, and FHLMC to expand its effort as fast as practicable to a level comparable to FNMA's but proportionate to FHLMC's size.

The new AHP must be an addition to, and not a substitute for, these important efforts. FNMA's and FHLMC's affordable housing initiatives have not been targeted so far to the income levels required under the AHP for multifamily projects, or to the real but still unmet needs in the single family area. FNMA's and FHLMC's programs operate under standards of underwriting designed for conventional, untargeted housing. Unfortunately, many worthy affordable housing projects find it impossible to meet these standards for reasons which do not necessarily include risk. An affordable housing program like the legislation recommends could address the needs of such low income housing projects which do not meet conventional underwriting standards.

Much of the testimony that has been given has addressed the need to upgrade FNMA and FHLMC capital standards. While the perception may be that additional capital is necessary to protect against existing risk, our experience with FNMA's and FHLMC's present programs suggests that they structure their programs so that they take little or no risk, even in their affordable housing ventures.

HFAs clearly understand what it means to maintain fiscal integrity and soundness. HFAs effectively act as state level secondary markets. Our ability to issue bonds to finance our housing programs is dependent on obtaining high financial ratings from rating agencies such as Standard and Poor's and Moody's. Since we are required by

state law to operate on a business-like basis and be financially self-sustaining, HFAs must be constantly aware of the bottom line. But we also know that financing truly low income housing may involve taking some risk. For example, our experience tells us that many low income needs cannot be met without sophisticated program structuring and the establishment of program reserves. HFAs have successfully financed such housing and believe FNMA and FHLMC can and should do so as well, but not within the more conventional underwriting standards applicable to their current affordable housing initiatives.

The proposed AHP establishes the necessary framework for the development of an alternative product line to meet the unique circumstances of low income housing. We strongly support the concept with the following specific suggestions.

1) The AHP should be designed to require FNMA and FHLMC to undertake low income housing activities beyond those permitted by their present underwriting standards. It should not be a grant program for a relatively few projects scattered across the country. Instead, program funds should be retained within the Corporations to leverage financing for targeted, low and very low income housing programs not presently undertaken by these Corporations.

2) The AHP should include a low income single family component for otherwise nonconforming low income loans which gives preference to areas, such as rural areas, where rental housing is frequently not viable.

3) FNMA and FHLMC should be required to devote a meaningful amount of funds to the AHP based upon some measure of their profitability. We are not certain that a percentage of dividends, as the legislation proposes, is the best way to measure the level of effort required in the new program. Other measures might include net earnings, some combination of net earnings and dividends, or even some significant portion of their overall secondary market activity which was clearly required to be committed to the kind of projects we are describing in this testimony. Whatever measure the Subcommittee determines is appropriate should result in a minimum of $1 billion in leveraged financing for low income housing under the new program.

4) The Subcommittee should take care to ensure that the AHP addresses unmet housing needs and is not permitted to be a substitute for FNMA's present level of effort in affordable housing or what we hope will be FHLMC's expanded effort.

THE ENTERPRISE FOUNDATION

Hope from Homes

Statement of
The Enterprise Foundation
Before
The Subcommittee on Housing and Community Development
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives

July 19, 1991

Mr. Chairman and members of the Subcommittee, it is a pleasure to have this opportunity to appear before you on behalf of The Enterprise Foundation and share our thoughts concerning regulatory proposals for the Federal National Mortgage Corporation ("Fannie Mae") and the Federal Home Loan Mortgage Association ("Freddie Mac"). I am Bart Harvey, vice-chairman of The Enterprise Foundation.

The Enterprise Foundation

The Enterprise Foundtion is a publicly supported nonprofit organization which operates in more than 70 cities, with more than 130 nonprofit groups, helping to provide decent, affordable housing to poverty level individuals and families across the country.

The Foundation assists grassroots nonprofit groups with their programs to rebuild housing and community in some of the most distressed neighborhoods in the country. Enterprise assists these groups with "seed" capital, assistance in the lowest cost means of rehabilitating buildings through its Rehab Work Group, special financing, and financial packaging assistance through its Enterprise Social Investment Corporation (ESIC).

To date, Enterprise has put over $300 million back into nonprofit sponsored housing through grants, loans, equity investments and technical assistance. This "seed" capital is leveraged many times over with private sector, state, local, and federal financing.

500 AMERICAN CITY BUILDING, COLUMBIA, MARYLAND 21044 • 301 / 964-1230

Comments on Fannie Mae & Freddie Mac

We have worked extensively with Fannie Mae and Freddie Mac, primarily in their on-going efforts to develop and deliver specially tailored financing programs to reach very low-income individuals and families. We are also keenly aware of Fannie Mae's and Freddie Mac's indispensable role in providing liquidity to the residential mortgage market as a means of enabling people of even modest means to achieve the American dream of homeownership.

Since their creation by Congress in 1938 and 1970, Fannie Mae and Freddie Mac, respectively, played an integral role in federal housing policy by creating an efficient, deep, national secondary mortgage market. Restated in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Fannie Mae and Freddie Mac were granted similar charters and purposes to:

- provide stability in the secondary market for home mortgages
- respond appropriately to the private capital market
- provide on-going assistance to the secondary market for home mortgages (including low- and moderate-income family mortgages involving a reasonable economic return) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for home mortgage financing.

To help fulfill their federal charter and its attendant public purpose, Fannie Mae and Freddie Mac have access to a number of benefits from the federal government conferring "agency status" and an "implied guarantee" of the federal government.

Backed by observable fact and HUD's, Treasury's, and OMB's own analyses, these companies have succeeded magnificently in expanding the base of investors in mortgages and even in attracting capital from international sources while reducing costs to American homebuyers. They have brought stability and standardization to the mortgage market and been creative and experimentally successful in offering new mortgage products. It is estimated that they have reduced mortgage costs to homebuyers by as much as three-quarters of a point, essentially making housing affordable to many more Americans.

Furthermore, they have provided a national mortgage market in good times and bad, and been a stabilizing factor during times of interest rate instability and real estate uncertainty. They have maintained operations in parts of the country beset by regional economic upheaval (such as the Southwest in the 1980's) and provided an on-going market when banks and thrifts would not make loans that could not be securitized. Clearly, their singularly focused mandate -- to provide

and facilitate residential finance -- makes these companies an important factor in national housing policy.

Moreover, Fannie Mae and Freddie Mac have well-served their Congressional intent to assist the secondary mortgage markets for low- and moderate-income families involving a reasonable return. Citing Fannie Mae's statistics, in 1990, the average loan purchased or securitized was $89,700 with more than 30 percent of such loans under $57,000. Freddie Mac had similar statistics. In their conventional single-family mortgage activities, both entities are reaching low-income populations, although more information is needed regarding actual income groups served.

In the multifamily arena, Fannie Mae purchased or securitized over $3 billion, fully ten percent of all such 1990 multifamily volume nationwide, and three times more than the next largest player. With multifamily production in a serious decline from a peak level of 669,000 units in 1985 to only 298,000 in 1990, Fannie Mae's consistent presence in this market is unique, and will prove, we believe, to be a vital bridge to sustaining increased activity anticipated as implementation of the preservation, RTC, HOME, and HOPE II programs begin.

Freddie Mac had been a major factor in the multifamily market and due to its loss experience withdrew its program subject to revising its underwriting parameters based on its experience. Freddie Mac anticipates announcement of its multifamily initiative in January 1992, and of an expanded commitment to meeting affordable rental housing needs.

In tandem with Fannie Mae's and Freddie Mac's servicing of low- and moderate-income individuals through the conventional market, are the specialized activities of both entities to meet the needs of low-income families which do not qualify for conventional financing.

Fannie Mae alone has committed to invest $10 billion, assisting 180,000 low- and moderate-income families, through a variety of special programs. Enterprise and other national nonprofit organizations have worked with Fannie Mae to overcome down payment, credit history and neighborhood difficulties to provide a number of single-family community lending activities. Additionally, Freddie Mac is pioneering a special $100 million multifamily program with the Local Initiative Managed Asset Corporation for low-income rental projects. Fannie Mae is also in the process of working with The Enterprise Foundation to create a nonprofit organization with the capital, capability and real estate expertise to bid for RTC properties under its affordable housing program and buy preservation properties which will be joint ventured or passed through to local nonprofit groups where possible.

Both Fannie and Freddie have been important forces in providing decent, affordable rental housing for homeless people and very low-income individuals and families. As leading investors in the Low-Income Housing Tax Credits nationally. These entities have been invaluable in pioneering the field and helping bring other reluctant corporate partners into the field. In the work done with The Enterprise Foundation, investment has been in projects in the heart of distressed communities with local nonprofit general partners. Commitments from both entities to Enterprise alone are for projects with a development cost exceeding $200 million.

Both entities have been responsive to finding ways to meet the needs of hundreds of thousands of families otherwise precluded from the housing market or from affordable rents. Both, we believe, are committed to continually experimenting with prototypes that, while soundly underwritten, reach lower income groups and strive for widespread replicability in meeting unique market needs for low-income people.

Meeting low income housing needs through both conventional and special programs is part of the public purpose of these entities achieved in tandem with their strength as private shareholder-owned corporations. These results are possible only if Fannie and Freddie have the financial and regulatory leeway to respond responsibly and creatively to reach low- and moderate-income family housing needs. It is a delicate balance that ultimately must be predicated upon a sound and safe institution which will not be a potential liability to the federal government, but which can also pass through its beneficial relationship in its public purpose programs.

Comment on Proposals

Before commenting on proposals regarding how Fannie Mae and Freddie Mac might expand their efforts to serve low- and moderate-income people, I would like to offer a view on certain proposals which might detrimentally affect the regulation of these entities. Three proposals are troubling for different reasons: bifurcated regulatory authority; arbitrary capital requirements; and prior approvals. These proposals, in our opinion, might dramatically change the way these government sponsored agencies deal with providing decent housing for low- and moderate income families. In making any changes, the utmost consideration must be accorded to the delicate balance and tension between safety and soundness and the public purpose of Fannie Mae and Freddie Mac.

First, the so-called dual regulatory provision would establish a new Office of Secondary Market Examination and Oversight solely to have authority over safety and soundness issues while general regulatory oversight would continue with HUD.

This dual approach severs the purpose for an implied government guarantee (lower borrowing rates than solely based upon credit risk) from the public purpose that this implied guarantee was meant to promote (lower secondary market rates; service to low- and moderate-income people). Where an office is set up to solely judge capital soundness, the presiding officers are judged upon conservative practices which could and usually do have an immediate and adverse impact upon the cost and availability of mortgage credit and practice to low- and moderate-income people. There is less reason to experiment and to enact new programs aimed at low-income families. In such an environment, Fannie and Freddie could also be expected to be rationally averse to even perceived notions of credit risk.

The Enterprise Foundation has seen too often with the Office of the Controller of the Currency, as an example, that risk-based premiums from the safety and soundness side discourages banks and thrifts from making needed multifamily loans while OCC, under the Community Reinvestment Act, is positively pushing these institutions to make those very same loans. The purpose of the new Office of Secondary Market Examination and Oversight should incorporate in its purposes the balance between adequate capital, the benefits to be conferred by an implied federal guarantee (because Fannie and Freddie do not have to have a triple A rating), and the benefits passed on to the consumer and low- and moderate-income families.

In light of this recommendation, the ability of the Directors of the Office of Secondary Market Evaluation and Oversight to arbitrarily impose a significant capital requirement, exceeding 20 percent of regulatory capital determined on risk-based criteria [Section 201(a)(3)] to cover management and operations risk, gives this official the ability to err on the conservative (riskless) side diminishing the asset of the implied federal guarantee to the entity and ultimately lessening the public purpose benefit by forcing riskless underwriting. It is our understanding that the Treasury has actively advocated Fannie and Freddie having a triple A credit rating, lessening the need for the federal backstop but also lessening the will and ability of these entities to carry out an important mission of passing benefits through to the consumer.

Finally, Enterprise would urge that Fannie Mae and Freddie Mac not be subject to the prior approval by HUD of each new program designed to meet its public purpose test [Section 303(b)]. It is our belief that these private corporations can better and more expeditiously experiment with new niche programs for affordable housing without needing HUD approval to proceed and test their efficacy. By trying a series of pilot programs, Fannie and Freddie will be able to test programs targeted to low income people, measure loan loss experience, and

craft for systemwide use new, adaptive products. We believe that speed, innovation, and adaptiveness in the affordable housing product is best achieved by allowing Fannie and Freddie the leeway to respond to set criteria for its public purpose programs.

Turning to the important issue of an Affordable Housing Program ("AHP") proposed in this bill, Enterprise commends the intent implied. It is critical that Fannie and Freddie meet the important needs of underserved people, particularly in the rental market. AHP is an attempt to point out the need in the multifamily housing market which typically serves the poorest populations of this country. However, rather than a program that is circumscribed in its scope, and would favor a limited few, Enterprise would far prefer to see that Fannie Mae and Freddie Mac expand their programs for low-income families, where possible on a financially sound basis, systemwide. We worry that AHP would be both a segregated minimum and maximum and would keep Fannie and Freddie from their important purpose of finding marketplace solutions to serving creditworthy low-income people.

Fannie Mae and Freddie Mac have made strides in that direction, but more is certainly needed, particularly in multifamily rental housing.

We would recommend as a first step that Fannie and Freddie provide on an annual basis more and better disclosure of volumes of single-family and multifamily loans made by income level, and by census tract (particularly in inner city areas). We would also suggest that Fannie and Freddie spell out special initiatives involving specific product lines, such as high loan-to-value loans, low down payment loans, nonprofit originated loans, employer assisted loans, or programs linked to new federal housing programs such as those contemplated under HOME, HOPE II, and HOPE III, in concert with the Federal Housing Administration (FHA), the RTC, or otherwise coupled to federal policy. Fannie and Freddie in cooperation with HUD should spell out annual volumes it might expect in each category or the effort being made to address the perceived credit needs which are not successfully being met.

Each year, Fannie Mae and Freddie Mac in review with HUD should examine their commitment to their public purpose based on disclosed, tangible results. This should include volumes of loans made in different categories and attempts to answer difficult financial structuring questions, should targeted volumes not be obtainable. At each annual review, these entities should also be willing to discuss their compliance with fair housing laws, and answer any questions regarding perceived discriminatory underwriting practices.

Fannie and Freddie might also set aside internally a special risk fund (for which they would get capital credit) to underwrite their new innovative programs, and to test those which could be instituted on a systemwide basis.

It is Enterprise's contention that carefully underwritten low-income housing is a viable, profitable business, and it is our hope that Congress will adopt proposals to sustain a regulatory climate that will enable Fannie Mae and Freddie Mac to do the creative work necessary to pioneer programs and products that can be replicated nationally.

Thank you.

SMITH BARNEY

July 18, 1991

The Honorable Henry B. Gonzalez
Chairman, Committee on Banking, Finance, and Urban Affairs
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Mr. Chairman:

I am a Vice President in the Research Department at Smith Barney with the responsibility for analyzing the nation's savings and loans and publicly traded Government-Sponsored Agencies (Fannie Mae, Freddie Mac and Sallie Mae) and making recommendations on the purchase or sale of these companies' equity securities to Smith Barney's institutional and retail investors. For your information, Smith Barney's current recommendations on Fannie Mae is "BUY" and on Freddie Mac is "HOLD." Smith Barney has four basic ratings: BUY, HOLD, AVOID and SELL.

Having read the proposed bill (H.R. 2900) regarding Fannie Mae and Freddie Mac's safety and soundness, I have concluded that, were this bill to be passed in its present form, I would be forced to recommend to Smith Barney's Stock Steering Committee that these recommendations be substantially downgraded. I believe that in its present form the H.R. 2900 would make the future raising of equity capital by either enterprise difficult and that such an event would have negative consequences for Fannie Mae and Freddie Mae's on-going debt and mortgage backed securities issuance.

While my prior association with Fannie Mae as Chief Economist in 1976-81 has certainly provided me with some perspectives on the economic and social roles of Fannie Mae and Freddie Mac, my comments here will be limited to the effects of H.R. 2900 on these enterprises equity valuation and their access to equity capital. Presumably, the enterprises' economic and social roles cannot be fulfilled if their access to equity and valuations are seriously impaired.

SMITH BARNEY,
HARRIS UPHAM & CO. INC.
1345 AVENUE OF THE AMERICAS
NEW YORK, NY 10105
212-698-6000

I have four major concerns with H.R. 2900:

1. The capital requirements as currently written would create considerable uncertainty on the part of investors as to what these enterprises' capital requirements would actually be. My concerns are twofold. First, the HUD office of Secondary Market Examination and Oversight seems to be granted unlimited power to set these enterprises' risk-based capital requirements at whatever level it wishes based on its assessment of managerial and operational risk. Second, by directly relying on stress tests to be performed by HUD, the bill adds further obstacles to investors trying to project these enterprises' interest and credit risk-based capital requirements. In my own determination of the enterprises' stocks attractiveness, a key element in formulating earnings and dividend projections is estimating when, and by how much, these companies are in capital compliance. The bill would make these projections "mission impossible." The task is not made easier by the unhappy relationship that has existed in certain periods in the past between Fannie Mae and HUD. As an equity analyst, I would much prefer that risk-based capital ratios themselves be made explicit in the legislation. That way I could project a company's capital needs and likely dividend policy under varying scenarios. My preference would have been a specific set of risk-based capital ratios derived from stress tests which presumably have already been done by the Treasury, HUD, Fannie Mae and Freddie Mac. Paul Volcker, in a study sponsored by Fannie Mae, provided a methodology as to how this could be done. The final legislation need not accept exact ratios proposed by this study, but the methodology employed could be used to arrive at an acceptable group of risk-based capital ratios.

2. The capital requirements as currently written would create considerable uncertainty on the extension of HUD. H.R. 2900 would require Fannie Mae and Freddie Mac to devote an amount equal to 20% of their prior year's dividends to grants for low-income housing. This would appear to violate an almost "sacred principle" that has been the basis of investor decisions on these companies since Fannie Mae's privatization in 1968, i.e., that the subsidization and grant functions, which had been a part of the "old" Fannie Mae since the Depression, would remain in HUD in Ginnie Mae and that Fannie Mae (and presumably now Freddie Mac) would channel funds into housing by operating as profit making companies and raising funds in the credit markets. The dividend tax as proposed will appear punitive to investors and, as a violation of this heretofore respected principle alluded to above, will be regarded by investors as the "nose under the camel's tent", opening the way for further, bigger dividend taxes in the future.

3. The compensation cap proposal would destroy and possibly politicize the high-quality management of the two enterprises. In my opinion, Fannie Mae is one of the best run financial companies in the United States. Moreover, its turnaround from virtual insolvency in 1981 is one of the more spectacular events in financial history and is in no small way due to the efforts of former CEO David Maxwell and the outstanding management team he assembled. Fannie Mae paid the market price for the best talent it could obtain. This policy differed markedly from the Fannie Mae in 1968-81, which unofficially kept its compensation just moderately over that prevailing in the government sector. In my opinion, as a result,

Fannie Mae in the late 1970's was handicapped in dealing with the fast changing financial and economic world of that era. As an analyst observing the two companies today, while I have the highest confidence in Mr. Brendsel and his current team at Freddie Mac, I believe there is no question that Freddie Mac is still recovering in terms of product development and marketing from its years in the government where its salary structure hindered its access to the best talent available and prevented it from always keeping its best people. I have yet to speak to an equity investor who is upset by compensation levels at Fannie Mae. Rather there is near unanimity that the rise in the stock reflected superior management and that the government was saved untold hundreds of millions of dollars, perhaps billions, by the turnaround engineered by its management. Compensation caps would be regarded as destructive by investors; capping at Freddie Mac levels (which still reflect its government years) would be regarded as completely illogical.

4. The new program approval process appears designed to thwart innovation in new housing finance vehicles and would further confine these companies to mediocrity. The new structure as proposed in H.R. 2900 seems to be designed to make the approval process for new programs to be long and arduous and to discourage innovation. The last decade has been characterized by spectacular change in the secondary mortgage market. Advances in computer and information technology and the mathematics of finance have made possible the development of all kinds of new mortgage products which have drawn large amounts of new investors and capital into housing, lowered the costs of housing credit to the American homebuyer and, yes, made large amounts of profits for investors in Fannie Mae and Freddie Mac. What's there not to like about this setup? I believe these innovations would have been greatly retarded had the structure of new program approvals been in place as proposed by this bill. Moreover, the regulatory apparatus virtually ensures that there will be continuous conflict between these enterprises and HUD and that both enterprises will need to devote considerable staff time to this process. Having been at Fannie Mae in the late 1970's and having witnessed first hand the debilitating effect the protracted conflict with HUD had on management personnel and the company's operations at that time, I would hope that a regulatory apparatus can be devised which, while preserving safety and soundness, is not conflict-prone.

Sincerely,

Peter Treadway

Peter Treadway, Ph.D.
Vice President
Research Division

National Low Income Housing Coalition

1012 Fourteenth Street, N.W., Suite 1500, Washington, D.C. 20005 • (202) 662-1530

Hon. Edward W. Brooke, *Honorary Chairperson* Barry Zigas, *President*

July 17, 1991

Hon. Henry B. Gonzalez
Chairman
Committee on Banking, Housing and Urban Affairs
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

On behalf of the Board and members of the National Low Income Housing Coalition, I appreciate this opportunity to write you concerning your proposed "Government Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991."

The National Low Income Housing Coalition represents a national network of community-based organizations, low income residents, and other public and private agencies working to provide decent affordable housing opportunities for low income people. The operations of Fannie Mae and Freddie Mac have never been as important in the fulfillment of this mission as they are today. Especially with the problems facing the FHA program and HUD's disarray in many areas, the influence of the secondary market institutions has grown. We commend you and your staff on the proposed legislation. We are especially interested in the proposed Affordable Housing Program in the legislation for both agencies.

The NLIHC received a copy of the legislation early on Wednesday morning. We are unable to testify at the scheduled hearings because of prior commitments that require key senior staff to be out of town. We do wish to submit a written statement on the legislation and ask that the hearing record be held open until at least July 26 for that purpose. In addition, I urge you to delay the scheduled mark-up of this bill. The proposed schedule will make it almost impossible for our organization to fully digest the proposals, discuss them with our Executive Committee and make considered recommendations. The legislation is important to the future shape of federal, state and local efforts to support affordable housing for low income people, and we wish to be as responsive to it as possible. The short times made available for review of the legislation, preparation of testimony and participation in the mark-up process will severely limit our ability to participate.

I congratulate you on proposing this legislation. Your leadership and consistent concern for assuring affordable housing opportunities for low income people have made a major difference in the lives of millions of people. The legislation evidences this same conviction and leadership. The NLIHC looks forward to working with you on this important effort, and appreciates the opportunity to share our views.

Thank you for your consideration.

Sincerely,

Barry Zigas
President

NTIC National Training and Information Center
810 N. Milwaukee Ave. □ Chicago, Illinois 60622-4103 □ (312) 243-3035

TESTIMONY SUBMITTED TO THE

HOUSE BANKING COMMITTEE

BY

GALE CINCOTTA

EXECUTIVE DIRECTOR OF NTIC

July 18, 1991

ON THE PROPOSED LEGISLATION TO IMPROVE

THE FINANCIAL SAFETY AND SOUNDNESS

OF GOVERNMENT SPONSORED ENTERPRISES

Mr. Chairman and members of the House Banking Committee; thank you for this opportunity to submit testimony on the proposed legislation to improve the safety and soundness of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Mortgage Loan Corporation (Freddie Mac). In my comments I will address myself to the amendments to the charters of these two corporations, specifically those sections which deal with contributions to the Federal Home Loan Bank's Affordable Housing Program.

I. Increasing Participation in the Low-Downpayment, Affordable Homeownership Market

The most effective way to achieve such an increase would be to establish standards for Fannie Mae and Freddie Mac in the areas of low- and moderate-income homeownership and low-downpayment lending. I propose that a reasonable standard would be for FNMA and FHLMC to make at least 60% of their loans to households purchasing homes under $100,000 and for 30% of those to be 5% downpayment mortgages.

Contributions to the AHP fund, as advantageous as they are, will not substitute for fundamental changes in the business practices of Fannie Mae and Freddie Mac.

As I have testified on numerous occasions, low-downpayment, flexible lending to low- and moderate-income households must become business as usual for Fannie Mae and Freddie Mac. The proliferation of special programs now being introduced is a very positive and important step, but will also be a source of enourmous confusion to lenders, especially smaller ones.

For the sake of accuracy I would like to point out that there appears to be a substantial difference between the openness of Fannie Mae and of Freddie Mac to low-downpayment, affordable mortgages. Fannie Mae was involved in prototype demonstration programs with NTIC and private mortgage insurers in 10 cities which evolved into the nationwide Community Home Buyers Program, and now several other major initiatives which are part of the Open Door to Housing program. Freddie Mac has been involved in demonstration programs in threa cities, and has not expanded the program, to our knowledge.

A reasonable standard of openness in underwriting must influence the routine business practices of the two corporations in order to achieve a rationally functioning and open secondary market. The ultimate goal, in other words, is to evolve beyond the numerous special niche programs to fair lending in general. When the secondary market functions as it should, fewer special programs will be needed to purchase loans made to low- and moderate-income borrowers who are good credit risks.

I must point out that despite the numerous new programs, there has not been a significant change in the number of low-downpayment

loans for affordable housing purchased or insured even by the most dedicated and sincere participants. Volume is extremely low and all parties acknowledge it needs improvement. The impediment to progress lies in the difficulty of introducing real change into underwriting practices. The flexibility I refer to above is the key to achieving results from all of the promising-sounding programs which have recently been introduced.

II. Contributions to the AHP

I believe it makes sense to require contributions to the AHP fund in order to provide resources for affordable housing and avoid creating a new bureaucracy, and that it is justified given the advantages conferred on FNMA and FHLMC by their government-sponsored status. Contributions, however, should not solely dependant upon earnings. In the first year both corporations should be required to contribute $50 million the first year, $75 the next, and $100 in the third year, <u>or</u> 20% of earnings, whichever is more.

It does not make sense, however, to limit that contribution to rental housing and limited equity cooperatives.

Flexibility in funding is always of great value, and is constantly being striven for. This goal is apparent in the recent switch from categorical housing programs to the block grant approach of H.O.M.E., and in the structure of the current Federal Home Loan Bank's Affordable Housing Program (AHP). Increased homeownership and affordable rental housing supply are necessary goals of a national housing policy, and assistance for both should be available according to the needs, desires, and particular circumstances of different localities and neighborhoods.

To limit Fannie Mae's and Freddie Mac's participation in the AHP to activities which will not contribute to their fundamental mission is also illogical. Many hearings have been held with the purpose of increasing the involvement of these two corporations in the affordable homeownership market. It seems counter to this goal to limit their contributions to rental housing in this rigid fashion.

Other concerns I have with the AHP contribution approach are serious:

A.) Will the distribution of the additional funding be as grossly inequitable as the present distribution, based on profits, of the AHP monies? Illinois and Wisconsin currently receive $2 million dollars while California receives $27 million. Contributions from FNMA and FHLMC should be distributed based upon need. If the addition of these funds led to a fairer distribution of FHLB AHP monies, this would also correct an existing inequity.

B.) Who will have access to the funds? Will interested groups be allowed to apply only through member institutions of the

FHLB? This should not be the case. Access to the funds should be broadened to permit general access to contributions from FNMA and FHLMC.

Apart from these few concerns, I support wholeheartedly the idea of using this resource for the development of low- and moderate-income rental housing and homeownership.

Sanford C. Bernstein & Co., Inc.
Investment Research and Management

767 Fifth Avenue, New York, New York 10153   212/486-5800   Cable BEEPERIOD

July 19, 1991

The Honorable Henry B. Gonzalez
Chairman, Committee on Banking, Finance, and Urban Affairs
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Mr. Chairman,

I am grateful for this opportunity to offer my opinion of the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991. In a sense, I speak for my firm's clients, institutional investors who are at risk both as taxpayers and as private investors in the equity and debt instruments of these two agencies, and are therefore concerned that they be adequately capitalized, properly supervised and regulated, and able to function profitably.

I would address the following points:

1) The risk-based capital requirement for credit-risk is not nearly specific enough (Sec. 201). A wide range of interpretations is possible from the language in the Act. It can be interpreted to call for a credit risk capital requirement of 0.60% to 1.60%, and using Fannie Mae as an example, from $2 billion to $7 billion of capital at June 30, 1991.

   We recommend that the standard developed by Fannie Mae and evaluated by former Federal Reserve Board Chairman, Paul A. Volker, of 0.74% (and 0.40% for recourse credit risk) be adopted in its place.

2) The open ended discretion of the Director to alter the management and operations risk capital requirement (Sec 201) should be eliminated, as it makes the capital standard so changeable as to be no standard at all, leading to uncertainty and management inability to plot long term strategy.

3) The proposed tax on dividends (Sections 121 k and 122 i), and the limitation on compensation (Sections 121 e and 122 e) should be struck, as both will undermine confidence of the private financial markets and impair the enterprises' ability to raise capital.

1) Capital Adequacy

The language in the Bill must be absolutely precise and utterly unambiguous, so that the Act achieves its intended objective. This does not appear to be the case with the draft Bill. It is possible, for example, to arrive at very different capital requirements under the credit risk component of the risk-based capital requirement (Section 201). For example, one could arrive at a requirement for Fannie Mae at June 30, 1991, ranging from as little as $2.0 billion to as much as $7.0 billion.

The standards must be reasonable, that is, the capital requirement must be stringent enough to afford substantial protection against loss to the taxpayer, without becoming so excessive as to hamper these agencies' ability to fulfill their housing mission. Too stern a capital requirement would force them to withdraw from the mortgage market, producing strains that would exacerbate the liquidity of the housing sector, and limit its contribution to the fledgling economic recovery. Mortgage rates might rise by as much as 1/4% to 1/2%, and possibly by much more.

Risk-based credit-risk requirement

The Bill, as written, while subject to various interpretations, appears to establish a credit risk standard that is far too high.

The worst three years' loss experience in a region containing at least 5% of the U.S. population, sustained for eight years, could imply a credit risk requirement of roughly 1.60% for Fannie Mae. Fannie Mae's loss experience, during the three worst years, adjusted for Fannie Mae's far more conservative underwriting currently, would suggest default frequency of roughly 1.40%, loss severity of 36%, and default losses therefore equal to 0.50% of the unpaid principal balance (UPB) of its loans and MBS.

What is wrong with such a standard? To achieve such an environment would require a 35% instantaneous decline in home prices ON A NATIONAL SCALE, and, that home prices then remain at that depressed level for eight years. The worst year for home prices in the United States since reliable statistics have been kept, beginning in 1968, was 1990, when home prices rose 0.6%. The worst decline at a point in time was November 1990 versus November 1989. They declined by 1.9% nationally. Such an assumption would place housing values at the end of year eight, 56% below where they would normally be, given home price appreciation at the 5% long-term trend rate over the eight year period (i.e. a $100,000 home that would normally sell for $148,000 at the end of eight years, would instead be selling for $65,000).

The Texas experience arose in a market where home prices fell as much as 40%, matching what is generally believed to have occurred in the Great Depression, and a Depression scenario is far too severe a criteria for establishing safety standards. Automobiles are subjected to crash safety standards. They must be able to withstand a front end collision with a brick wall at 30 MPH, without loss of life to the passengers. But not at 90 MPH. The credit-risk component of the risk-based capital requirement, at least under the most conservative interpretation of how it would be calculated, is far too harsh.

An Alternative Standard for Credit Risk

Fannie Mae has developed a set of risk related capital standards to account for both interest rate and credit risk.

In a letter to Fannie Mae's Chairman, signed by former Chairman of the Federal Reserve, Paul A. Volker, James D. Wolfensohn Inc. evaluated Fannie Mae's proposed standards for both interest rate and credit risk, under similar scenarios for interest rates and credit stress to those proposed under the risk-based capital requirements in the legislation. He concluded that these standards (non-recourse credit risk 135:1 or 0.74%, recourse credit risk 250:1 or 0.40%, and interest rate risk for on-balance sheet mortgages at 50:1 or 2.00%) in conjunction with subordinate debt comparable to levels then outstanding, would assure that "the risk of loss to the taxpayer due to the insolvency of Fannie Mae would be remote".

We published a major research study of Fannie Mae's ability to withstand a 600 basis point rise in interest rates over a three year period in July, 1989. In February, 1990, we evaluated Fannie Mae's ability to withstand a Texas-style housing bust, and credit crunch, simultaneously. We concluded that not only would Fannie Mae's capital not be wiped out, but also that Fannie Mae would remain profitable.

We recently developed a mortgage default model, very similar to those utilized by the mortgage agencies themselves, which is designed to predict mortgage default experience given any scenario for home prices. We then evaluated both Fannie Mae's and Freddie Mac's ability to deal with three different home price scenarios, all negative. We concluded that their ability to withstand adverse housing markets, far worse than any that have been seen on a national scale in this country since the Depression, was substantial.

We believe that the standards which Fannie Mae developed, and which Mr. Volker and others, including ourselves, have evaluated, should be adopted for the credit-risk component of the risk-based capital requirement for single family, fixed rate mortgages (recourse and collateralized credit risk equal to 0.40%, non-recourse credit risk equal to 0.74%).

We used our mortgage default model to ascertain what decline in home prices, then maintained at that depressed level for the eight years stipulated in the Act, would produce an aggregate loss of 0.74%. It would require an instantaneous decline of 20% on a national scale maintained for eight years.

Credit risk standards for multi family mortgages and ARM mortgages could be set at the single family fixed rate mortgage standard adjusted for the difference in default frequency of these instruments. If ARMs made at 80% LTV default 1.5 times as readily as fixed rate mortgages, the requirement for ARMs would be 1.5 x 0.74% = 1.11%.

I would be happy to provide additional explanatory text and exhibits if it would be of assistance to you, to support and explain these calculations and opinions.

Risk-based Interest Rate Risk Requirement

In 1989 we conducted an in depth research study over a five month period, and published a 200 page research report which evaluated Fannie Mae's ability to withstand a

600 basis point rise in interest rates over a two year period. This is a scenario very similar to that posed by the rate-risk stress test in the Act. We concluded that the net interest margin would decline by 43 basis points. Fannie Mae has further reduced its rate sensitivity over the past two years, by funding 20%-25% of its long-term fixed rate mortgages with long term callable debt.

Fannie Mae currently earns roughly 120 basis points pretax on its balance sheet, exclusive of float and equity that is associated with the mortgage backed securities (MBS) business, and before credit costs. After allocating 30 basis points of this to cover the credit risk requirement on loans, this leaves 90 basis points pretax. A 45 basis point contraction, as a consequence of a 600 basis point rise in rates, would leave 45 basis points pretax. That is, the company would continue to earn roughly $600 million on its $140 billion balance sheet, $123 billion of loans and $17 billion of investments, at the nadir of profitability, roughly 3 -4 years out, and would then recover.

The two scenarios simultaneously ... 1) home prices down 20% nationally, and 2) rates up 500 - 600 basis points, sustained for seven or eight years, and at the trough, Fannie Mae would earn roughly $250 - $300 million before taxes. While this would constitute a drop of 86% from this years' pretax income of $2.0 billion, it would remain profitable.

It would not be a question of how long until its capital would be exhausted. Its capital would be growing.

2) Management and Operations Risk

This requirement should not be great, as it is largely redundant with credit and rate risk. However, it should not be made open-ended subject to the discretion of HUD, as this would make the total capital requirement potentially so changeable, as to create enormous uncertainty for management that would prevent the kind of long term planning and perspective that is the underpinning of sound management strategy.

3) Political Risk: A Tax on Dividends

Investors in the debt and equity of Fannie Mae and Freddie Mac are sensitive to an element of risk that is not mentioned at all in this Act, Political Risk. To the private financial markets this risk is the most serious that confronts the GSE's, as it is beyond the control of their managements' skills.

What is political risk? This question is easily answered if you ask yourself how you would feel, placing your money at risk, in a venture whose profits accrue to you only after a third party has extracted an interest, the amount of which interest is subject to change, at any time?

To the private investor, the proposed 20% tax on dividends looks like the camel's nose under the tent. It would assuredly have a negative impact on the way these enterprises are

viewed, negatively affecting the confidence which the financial markets have in their ability to analyze the long term prospects of the GSEs, and negatively impacting the ability of the enterprises to raise capital to finance housing, should they so require.

Political Risk: Limitation of Management Compensation

Under political risk, as well, belongs the limitation on management compensation. It seems ironic, that the Act sees fit to exclude the officers and employees of the Office of the Director from limitations upon compensation (Sec. 104), presumably so the Director can attract the technical expertise necessary to properly regulate the enterprises, while placing limitation on the compensation of executive officers of Fannie Mae and Freddie Mac. After all, the latter are paid by shareholders, the former by the taxpayers, and both are entrusted with the responsibility and duty to ensure the safety and soundness of the enterprises.

The reaction of the investment community to limitation on management compensation is very negative. Such limitation erodes confidence. And the strength of a financial institution rests as much upon the way it is perceived (i.e. investor confidence in how well it is managed), as upon its capital base.

Conclusion

It is fitting that the process begun by the Congress in concert with the Administration, by enacting FIRREA, be continued and completed with this Act. It is in the interest of all concerned parties, that this Bill ...

a) define reasonable, unambiguous, capital standards

b) that are not subject to open ended change by the regulator, and

c) not impose a tax on dividends or limit the enterprises' ability to acquire the best possible management talent, by imposing arbitrary limitation on compensation of officers and employees.

Respectfully,

Jonathan E. Gray
Senior Research Analyst

TESTIMONY OF

PAUL S. GROGAN
PRESIDENT
LOCAL INITIATIVES SUPPORT CORPORATION

ON

GOVERNMENT SPONSORED ENTERPRISES

BEFORE THE

SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT

COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS

JULY 19, 1991

TESTIMONY OF PAUL S. GROGAN

Mr. Chairman and members of the Subcommittee, I appreciate the opportunity tc testify on proposed legislation (H.R. 2900) concerning Government Sponsored Enterprises (GSEs), including the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). My name is Paul Grogan. I am President of LISC, the Local Initiatives Support Corporation.

About LISC, CDCs, and GSEs

LISC is the nation's largest nonprofit organization supporting nonprofit low-income community-based development corporations (CDCs). Since 1979, LISC has raised $479 million from over 700 private donors and has assisted over 750 CDCs in the development of 26,000 low- and moderate-income housing units and 6.5 million square feet of commercial and industrial space, attracting an additional $1.5 billion for these community development projects.

CDCs have proven themselves against daunting odds. Operating in the toughest neighborhoods in America, CDCs emerged in the 1980s despite the federal government's budgetary withdrawal, an epidemic of drug abuse and violent crime, a housing crisis, and a national crisis of confidence that any social programs can work. But CDCs are succeeding indeed, with a traditional American formula of self-help, pragmatism, and perseverance.

LISC's mission is to help CDCs not just to develop projects, but also to transform distressed inner-cities into strong diverse communities that are good places for low- and moderate income families to live, and to bring these communities into the social and economic mainstream of this country.

But CDCs can continue to grow, and low-income neighborhoods can rejoin the economic mainstream, only if they have sufficient access to capital. Under your leadership, Mr. Chairman, the Housing Subcommittee and the full Banking Committee have recently taken two major steps in the right direction: last year by creating the National Affordable Housing Act, which places CDCs squarely in the center of a new federal housing policy; and earlier this summer, by preserving the Community Reinvestment Act after the Financial Institutions Subcommittee had voted to gut it. GSE legislation should be a third important step, because Fannie Mae and Freddie Mac have the capability to connect low-income communities with national capital markets, which is, as you know, a big part of the financial mainstream. It is almost impossible to stabilize a neighborhood if banks will not lend there because they cannot sell the loans on the secondary market.

That is why LISC has been devoting a great deal of effort to work with Fannie Mae and Freddie Mac. While both institutions can and should do much more, we believe progress can be achieved. On a broad scale, Fannie Mae has committed $10 billion to

affordable housing and we understand Freddie Mac will be making a commitment of its own shortly. Our work with Fannie and Freddie has focused on their unique capacity to provide wholesale capital for low-income housing at market rates. We believe that this approach is consistent with both the mission and core business of these GSEs, and therefore has the potential for expansion and long-term impact. We have focused on three areas: mortgage financing for single family homeownership; mortgage financing for low-income multifamily rental and cooperative housing; and equity financing for low-income rental housing.

- In 1987, LISC began HomeSight, a comprehensive financing program to help CDCs produce affordable owner-occupied houses here in Washington, DC. Fannie Mae joined LISC, local lenders, and the District government in the effort. Fannie's role is to purchase first mortgages originated by the financial institutions. So far, CDCs have used HomeSight to produce 150 homes. We are about to announce the support of Fannie Mae and the Home Improvement Industry Affordable Housing Coalition to expand the concept to several other cities nationwide.

- Earlier this year, Freddie Mac and LISC's own secondary market affiliate, the Local Initiatives Managed Assets Corporation -- LIMAC -- reached agreement on a bold new program to provide long-term fixed-rate financing for low-income multifamily housing. The program marks Freddie Mac's re-entry into multifamily housing mortgage finance. Under the initiative, local financial institutions will originate the mortgages and sell them to LIMAC, retaining 20 percent of the risk on a pro-rata basis. LIMAC will pool the mortgages and swap the pools for mortgage backed securities guaranteed by Freddie Mac, with LIMAC providing additional credit enhancement to Freddie. LIMAC will then market the Freddie Mac-guaranteed securities to investors, including pension funds and insurance companies. The initial program of $105 million has great potential for expansion.

- Both Freddie Mac and Fannie Mae are investors in LISC's low-income housing equity funds. Since 1987, LISC's equity funds have raised $269 million from corporations based on the Low Income Housing Tax Credit for CDC-sponsored developments. We are investing these funds in 180 CDC sponsored projects with 8400 low-income housing units. Freddie Mac is our largest single investor at $38 million, and last year was one of our two lead investors, along with Warren Buffett's Berkshire Hathaway, at $25 million. As you know, the Credit is the primary federal tool for producing low-income rental housing. We hope you will do everything possible to ensure its extension this year on a permanent basis.

Affordable Housing Program

The proposed Affordable Housing Program (AHP) is the part of the bill that most directly addresses the needs of low-income housing. We appreciate and endorse the objective of involving Fannie Mae and Freddie Mac more deeply in low-income housing.

However, we are concerned that the AHP could have unintended adverse effects and will not take advantage of these GSEs' unique and pivotal role in mortgage finance. Congress has already clearly embarked on a policy that Fannie Mae and Freddie Mac should be essentially private institutions that can attract private capital while fulfilling their federal charter to foster affordable housing. Investors would be understandably concerned if Congress requires Fannie Mae and Freddie Mac to contribute subsidy funds as proposed under the AHP, especially since the AHP could set a precedent for other similar requirements in the future. The result could be to impede Fannie Mae's and Freddie Mac's ability to raise investment funds. We believe that the government should be the primary source of housing subsidies. Congress should provide full funding for the HOME program and permanently extend the Low Income Housing Tax Credit.

Moreover, the AHP could send the wrong signal to Fannie and Freddie that low-income housing -- and especially low-income rental housing -- is a charitable activity rather than a business activity. This would be equivalent to telling a bank it can fulfill its CRA responsibilities by making charitable contributions rather than making loans. Charitable contributions on a voluntary basis are entirely appropriate and should be strongly encouraged, as we discuss below, but what matters most is that low-income housing and communities have access to the mainstream mortgage financing that only the secondary market can provide. That this is the message conveyed to Fannie Mae and Freddie Mac is particularly important at a time when their commitments to low-income housing are still being institutionalized.

As an alternative to the AHP as proposed, we would offer the following.

- First, Fannie Mae and Freddie Mac should collect and disclose data on the loans they buy about the income, race, and gender of homebuyers and the affordability of rental housing to low-income people, as well as the location of the housing and whether government subsidies are involved. Of particular interest are whether the housing is located in low-income census tracts, and how many beneficiaries meet various federal income standards (i.e., 50, 60, and 80% of area/state median.) Where multifamily housing is involved, the focus should be on the affordability of initial rents and the targeting requirements of any public subsidies involved in the projects. Without such baseline data, we cannot really know what the GSEs are doing or whether progress is being made.

- Second, Fannie and Freddie should announce publicly their own targets for addressing the housing finance needs of low-income people and communities, on an annual basis, as well as how they intend to meet them, and then report annually to Congress on their progress.

- Third, Fannie and Freddie should voluntarily embark on the development of a series of financing experiments, and commit the necessary capital to underwrite them. The premise should be that there are many innovative ways to fill special low-income financing market niches at an acceptable level of risk. While most of these financing products may never achieve the volume of activity that Fannie and Freddie normally seek in a financing product, they can generate a market-rate yield with low default rates, if only they get the chance to prove themselves. Until this track record is demonstrated, Fannie and Freddie should decide voluntarily develop and underwrite these specialized products. Fannie and Freddie should describe these efforts in their anuual report to Congress.

- Fourth, Fannie Mae and Freddie Mac should expand their corporate giving programs, also on a voluntary basis. Low-income housing and community development and strengthening CDCs should be prominent parts of these programs. We applaud Fannie Mae's initial efforts in this regard and urge Freddie Mac to follow suit. Fannie and Freddie are among the leading corporations in the United States today, and they should join the leadership ranks in corporate giving, especially in light of their affordable housing mission. Twenty-five companies, including Cummins Engine, Adolph Coors, Pillsbury, RJR Nabisco, Hewlett-Packard, Shearson Lehman Hutton, and Gannett each contribute over 3 percent of their net earnings before tax. Fannie and Freddie should describe their contributions efforts in their annual report to Congress.

Other Provisions

Other proposed provisions besides the AHP will have indirect but important consequences for low-income housing, and I would like to highlight some of these as well.

- First, a new and independent Office of Secondary Market Examination and Oversight (OSMEO) would be established within HUD with regulatory responsibility for the safety and soundness of Fannie Mae and Freddie Mac, but HUD itself would have broader oversight responsibilities. To prevent a problem of conflicting regulators, we believe that the same entity that oversees safety and soundness should also oversee the GSE's broader housing mission. While safety and soundness is in everyone's interest, we are concerned that a regulator focusing only on safety and soundness will not take into account the impact of its actions on low-income housing and communities. We have heard

of a similar phenomenon among federal banking regulators, where the requirements of safety and soundness examiners thwart the efforts of CRA examiners to encourage community investments. It will be hard for Fannie Mae and Freddie Mac to pursue low- and moderate-income housing initiatives vigorously in the face of conflicting (or indifferent) regulators.

- Second, HUD should not have prior approval authority for new products proposed by Fannie and Freddie. This requirement would probably stifle the creativity needed to generate the kinds of new financing products that Fannie and Freddie should be developing to serve low- and moderate-income people and neighborhoods.

- Third, OSMEO should not have the power to increase Fannie Mae's and Freddie Mac's capital requirements arbitrarily. This would be especially problematic if OSMEO has no responsibility for oversight on the GSEs' broader housing mission. It would be too easy for OSMEO to reason that if safety and soundness is the only objective, then requiring more capital is better.

In short, these provisions all would tilt Fannie Mae and Freddie Mac away from the kinds of innovations needed to serve low-income people and communities, and Congress should not proceed with them.

Conclusion

This concludes my comments. I appreciate your consideration of them.

Goldman, Sachs & Co. | 85 Broad Street | New York, New York 10004
Tel: 212-902-6719

Robert G. Hottensen, Jr.
Vice President
Investment Research Department

Goldman Sachs

July 19, 1991

The Honorable Henry B. Gonzalez
Chairman, Committee on Banking, Finance, and Urban Affairs
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Mr. Chairman:

Thank you for giving me the opportunity to express my views. My name is Robert Hottensen. I wish to make several points with respect to the subcommittee's draft legislation on regulatory matters and oversight of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac):

1. I am a vice president and senior securities analyst at Goldman, Sachs & Co. My job consists of informing institutional investors about developments affecting mortgage finance companies, such as Fannie Mae and Freddie Mac. In fulfilling my duties, I regularly and consistently conduct dialogues with industry management, housing officials, investors, representatives from trade groups, and economists, among other professionals. In short, my views have been synthesized through contact with a broad array of housing, markets, and mortgage finance professionals. In the course of my work, I have developed strong opinions on some of the proposals contained in the draft legislation.

2. I applaud your efforts and the intent to provide greater regulatory certainty and accountability to Fannie Mae and Freddie Mac. I believe that the marketplace would react positively to fair, but tough enforcement of capital rules, and all parties would benefit from routine and thorough examinations by HUD. In fact, the marketplace, in developing greater certainty on capital adequacy, credit quality, etc., can best express the efficient prices at which securities, including companies' common stock, ought to trade. This efficiency enables these companies to more effectively access capital markets in support of their critical missions in mortgage finance. However, I believe that the kind of open-ended regulatory oversight proposed by the legislation would be counterproductive. Specifically, capital markets thrive on certainty and are in disarray in direct proportion to uncertainty. The needs of homeowners and mortgage markets are well served by Fannie Mae's and Freddie Mac's efficiency and consistent discipline in the mortgage markets as they utilize capital to maintain a continuous flow of funds for housing and tight mortgage spreads to long-term Treasuries. Once capital rules are established and determined to be reasonable by the marketplace, it seems counterproductive to allow arbitrary intrusion into the operating affairs of Fannie Mae and Freddie Mac. I believe that this open-ended option to impose tougher requirements, new standards, or approve product changes would diminish Fannie Mae's and Freddie Mac's abilities to access the capital markets (both debt and equity) and diminish their effectiveness.

July 19, 1991
Page 2

3. Although I support your commitment to low-income housing, I believe that a specific requirement tied to dividends is counterproductive. I believe that the capital markets would react harshly to any requirement that funds be allocated from dividends based on a specific formula. Should a "dividend tax" be imposed, the message sent to the capital markets would be the wrong one. I believe that the capital markets would interpret the formula as simply a first step to "federalizing" and politicizing Fannie Mae and Freddie Mac. I think that the needs of low-income housing are best served by a strong Fannie Mae and Freddie Mac, with maximum access to the capital markets. We support Fannie Mae's and Freddie Mac's commitment to affordable housing and believe that the best interests of low-income, affordable housing are served through the leveraging of Fannie Mae's and Freddie Mac's access to the capital markets.

4. The proposal to cap management salaries sends the wrong signal to the marketplace and would significantly diminish Fannie Mae's and Freddie Mac's ability to attract the high-quality financial executives necessary to efficiency carry out their mission to housing in a safe and efficient manner. We have been impressed with the ability of private-sector incentives to attract key people in both organizations and the discipline evident in the managements' approach to housing. I am fearful that hamstringing their ability to attract key people long term would diminish that effectiveness and be counterproductive to the best interests of taxpayers. I think that Fannie Mae and Freddie Mac need to maintain the same financial incentives as those available to other shareholder-held corporations.

Sincerely,

Robert G. Hottshean, Jr.

RGH:pd

NATIONAL ASSOCIATION OF REAL ESTATE BROKERS, INC.

Executive Offices
1629 K. Street, NW, Suite 605
Washington, DC 20006
Telephone: 202-785-4477
Telefax: 202-785-1244

Evelyn A. Reeves
President/Ceo

Position Statement on the regulation of Government Sponsored Enterprises by The National Association of Real Estate Brokers, Inc.

NAREB is the largest and oldest minority real estate trade association in America. Founded in 1947 NAREB has local chapters in forty two states and national headquarters in Washington, D.C. since 1970. NAREB members principal market is urban America.

The GSE operating mandate of private investors serving a public purpose has worked well for the investor and much of the home buying public. It has not worked as well as it could for the taxpayer, and not as well as it should for minorities and women, particularly those in America's urban centers.

There have been many reports on the effectiveness of Fannie Mae and Freddie Mac. The most notable from the Congressional Budget Office (CBO) and the General Accounting Office (GAO).

Other studies point out the ineffectiveness of the general private lending community (primary, secondary and insurers) in urban and minority markets. The University of California at Berkeleys' study of mortgage lending patterns in Oakland, CA by professor David Rossen, to the Institute for Public Policy Studies at Temple University on the same subject by Dr. Ira Goldstein both point out the overwhelming disparity of availability of mortgage capital to finance housing in urban centers and the overall minority population.

In light of the banking crisis no one disputes the necessity of reasonable risk based capital requirements for the GSE's. The Treasury Departments proposed requirements seem to place the GSE's in the same category as banks and savings institutions. The GSE's hoped for new capital requirements and regulation is predictably self serving, leaving the taxpayer more exposed than feasible.

Although HUD has for some time regulated Fannie and under FIRREA now regulates Freddie their loan underwriting criteria was anti-urban areas and their personnel, anti-minority and women lending. There has been no strong mandate from HUD for these agencies to provide loan products for the urban community. The programs now being promoted in urban and minority areas are a result of the Community Reinvestment Act of 1977 (CRA). The CRA lending program became a focus of lenders because of their need to grow, not any perceived community responsibility. Since these conventional lenders are clients of Fannie and Freddie the GSE's got involved to aid and abet their urban disinvesting, racial and gender discriminating clients. The GSE and lending industry alliance agreed universally that urban and minority or CRA lending created highly speculative and risky investments. CRA lending did not begin to be taken seriously until federal regulators stopped the purchase of a failed Arizona institution by Continental Bank of Illinois in 1989.

NAREB had participated in such challenges from 1979 with none being successful until the ACRON (Association of Community Organizations for Reform Now), lead challenge of Continental.

The GSE's claims of providing historic regional stability of mortgage rates and lower origination fees to borrowers must be challenged. Challenged by the facts of urban lending instability producing mortgage rates and originating cost 200 basis points, in both categories, above the regional averages. Further producing an origination to loan closing ratio of 3 to 1 when comparing urban/minority and women mortgage seekers to the regional majority.

The conventional lending community did not chose to develop cost effective means of loan origination and closing in CRA areas. Thereby supporting their claim of these areas being unprofitable to do business in.

These practices contribute to urban social and economic decay, increasing overall cost to the taxpayer. GSE's must be mandated by regulation to produce profitable urban lending products. The efforts of Fannie Mae's Low and Moderate Income Division are admirable, but still much too little, while its getting much to late. Freddie Mac does all it can to avoid the issue of CRA, urban or minority lending. There is much more time and money spent by these agencies putting a good face on what efforts are being made in urban lending than the development of programs that can profitably serve this neglected segment of society. The favorable CRA ratings received by mortgage lenders for anemic production of affordable housing and minority loans encourages minimal investment in CRA program development.

Fannie Mae records prove CRA lending can be profitable. Local banks and private mortgage insurers have data also supporting this. NAREB members throughout America have developed or worked with profitable affordable housing and community development efforts as have national and local non-profit groups. Our biggest impediment is the lack of sustained commitment to make the CRA loan a profitable community building, tax saving and municipal revenue producing standard product line.

To enhance long term stability of the GSE's while fulfilling their public/private purpose NAREB feels new regulatory mandate must include:

1. Reserve a specific percent of profit before employee bonus, not to be below a minimum amount, for the development of CRA targeted loan products.

2. Mandate a specific percent of CRA loans be a part of every Real Estate Mortgage Investment Conduit (REMIC) and Collateralized Mortgage Obligation, (CMO), sold by Fannie Mae and Freddie Mac.

3. The GSE's hold quarterly regional advisory commission public forums on CRA lending activities in conjunction with their regular advisory committee or Board of Directors meetings.

4. A progressive monetary penalty for less than 15% of the loans purchased having a 95% loan to value ratio to be assessed on a semi-annual basis.

5. Placing qualified members of NAREB on their Board of Directors, National and Regional Advisory committees. (The National Association of Realtors opposed every piece of fair housing and lending legislation before congress, including CRA and Title Twelve of FIRREA, but have manadated slots on the GSE's Board and Advisory Committee).

6. Employment of qualified minorities in vice president and above positions while initiating goal (not quota) oriented inclusion of minorities in other management level positions, being reflective of the area workforce.

7. The aggressive inclusion of urban based minority and women businesses in contract services for the GSE's.

NAREB first began working with Fannie Mae in 1974. Our members have infrequently served on its Board of Directors, Advisory Committees and special task forces throughout our relationship. NAREB's involvement helped establish the Low and Moderate Income Housing Division at Fannie Mae. Members of NAREB and Fannie Mae will attest the relationship is necessary and must be improved to establish lasting positive results.

If this relationship is established by regulation it takes the heat off the GSE's with their banking clientele and reduces existing staff frictions on the issue of minority inclusion. The process of profitable CRA lending works best when the historical minority business community is included on a meaningful basis. This inclusions will enhance the safety and soundness of the urban real estate market while decreasing economic urban decay and increasing revenue to urban municipalities. Thereby truly fulfilling the purpose of the GSE's in a safe sound and profitable manner.

cc: Senator Donald Reigle
Senator Alan Cranston
Congressman Henry Gonzalez
Congressman Kweisi Mfume

Written Testimony to the United States House of Representatives Subcommittee on Housing and Community Development on the Subcommittee's Consideration of the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation

Submitted by:
Mack Powell
President
California Association of REALTORS®
July 17, 1991

INTRODUCTION

As President of the California Association of REALTORS®, the statewide trade association representing the interests of 145,000 real estate licensees in California, I am grateful to have the opportunity to present C.A.R.'s perspectives on the two government-sponsored housing enterprises--the Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC).

C.A.R. would like to preface its remarks by emphasizing that it is strongly committed to the continued vitality of the FNMA and FHLMC. The need for accessible and affordable finance is a crucial one for homebuyers in the high-cost California housing market. The importance of the mortgage affordability provided by the FNMA and FHLMC has grown in recent years in high-cost housing states like California due to the decreasing applicability of low-cost FHA financing. Static loan limits and harmful program changes such as restrictions on the financing of non-recurring closing costs have served to make FHA-insured loans less and less of an option for moderate-income and first-time homebuyers in California.

By improving the efficiencies of the mertgage market, the FNMA and FHLMC represent a cornerstone of the federal government's commitment to increased rental and ownership opportunity for the American people. We believe, and all evidence points to the fact, that the FNMA and FHLMC have fulfilled their mission in a fiscally conscientious manner.

In general, C.A.R. believes the subcommittee's draft bill, the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991, represents an important initial step towards meeting the dual goals of preserving the critical home financing role played by the FNMA and FHLMC and minimizing any financial risk posed by the FNMA and FHLMC to the nation s taxpayers. We strongly concur with the preamble of the subcommittee's draft bill which states that the FNMA and FHLMC "pose minimal financia risk to the Federal Government" and that "the continued ability of the FNMA and FHLMC to accomplish their public missions is important to providing housing in the United States and (to) the health of the nation's economy."

C.A.R. believes that in many respects the subcommittee's draft legislation proposes a superior approach towards regulating and minimizing the risk of the GSEs than is proposed in the Treasury Department's GSE legislation (HR 2747). While our testimony go into considerably more detail, C.A.R.'s primary concerns with respect to GSE legislation are:

- The preeminent responsibility of the regulator of the FNMA and FHLMC should be to ensure that the federally sponsored housing GSEs meet their mandate of providing American homebuyers with access to affordable mortgage credit;
- Oversight of the FNMA and FHLMC should be vested in a department of the government whose primary responsibility is housing so that the FNMA's and FHLMC's commitment to increased housing opportunity can be best balanced against the need to manage their business operations in a prudent manner
- Capital standards instituted for the FNMA and FHLMC should be commensurate with the relatively low degree of risk associated with nvestments in residential mortgages;
- The authority to determine the proper capital standards for the FNMA and FHLMC should remain with the Congress, rather than be relinquished to the Executive Branch of government; and,
- Methods of determining the capital adequacy of the FNMA and FHLMC, such as through interest rate and credit risk stress-tests, should be specifically written into law by the Congress.

We hope the Housing Subcommittee and full House Banking Committee will consider C.A.R.'s concerns as it marks-up its housing GSE legislation.

Oversight: Safety and Soundness vs. Housing Mission

C.A.R. supports vesting the authority to oversee the FNMA and FHLMC, both programmatically and in terms of safety and soundness, within HUD, as is proposed in the subcommittee draft. While we have misgivings over the seeming lack of support and enthusiasm HUD has shown for its FHA program in recent years, C.A.R. believes that regulation of the FNMA and FHLMC rightly belongs in HUD. We do believe, however, that HUD's preeminent regulatory

responsibility with respect to the FNMA/FHLMC should be to ensure that the federally sponsored mortgage market entities meet their mandate of providing American homebuyers with access to affordable mortgage credit.

The draft bill would delegate the authority to regulate the FNMA and FHLMC to two offices within the Department of Housing and Urban Development. A new Office of Secondary Market Examination and Oversight (OSMEO) would be established within HUD to regulate the safety and soundness of the FNMA and FHLMC. The Director of the OSMEO, who would be appointed by the President and confirmed by the Senate, would be responsible for: establishing capital standards to measure the risk involved in proposed new FNMA/FHLMC activities; examining the financial condition of the FNMA and FHLMC; appointing conservators for the FNMA and FHLMC if their critical capital ratios fell below minimum levels; and, approving or disapproving dividend payments by the FNMA/FHLMC in the event the risk-based capital, minimum capital or critical capital levels of the entities fell below minimum, proscribed standards.

While the Director of OSMEO would be responsible for ensuring the safety and soundness of the FNMA and FHLMC, the HUD Secretary would retain authority over the GSE's programmatic housing mission. Furthermore, the bill would require the HUD Secretary to approve new products proposed by the FNMA and FHLMC.

Thus, the subcommittee print proposes a division of regulation within the Department of Housing and Urban Development with respect to the housing GSEs. The OSMEO Director would be responsible for ensuring that the FNMA and FHLMC conduct their business operations in a prudent manner at as sma l as risk to taxpayers as possible while the HUD Secretary would ensure that the FNMA and FHLMC meet their statutory mission of ncreasing the rental and ownership housing opportunity of the American people.

While such a division of regulation may make sense on paper, C.A.R. is extremely concerned that the proposed regulatory arrangement will mean that new and innovative FNMA/FHLMC products and programs will be stifled and delayed by the bureaucratic process. One arm of HUD will decide whether to permit new activities while another arm will determine under what capital requirements the new activity must be conducted. Both the FNMA and FHLMC have been extremely successful at responding quickly to rapidly changing market conditions. C.A.R. has serious reservations as to whether HUD will be able to approve and decide upon the proper capitalization level for new activities proposed by the GSEs in as timely a fashion.

C.A.R. also has reservations about implementing a regulatory schome which, in practice, would verge on micromanagement of FNMA and FHLMC activities. Why should the FNMA and FHLMC be forced to obtain prior HUD approval for a proposed new activity if the entity's capital equals or exceeds minimum risk-based capital requirements? We believe such intervention in the business activities of the FNMA and FHLMC is unnecessary if the entities are, in fact, well-capitalized. Such micromanagement of the housing GSEs could well inhibit their abi ity to respond quickly to housing market conditions through the development of innovative products and services such as the recently developed 3/2 Option loan.

We emphasize that the FNMA and FHLMC are privately owned corporations, which have been meeting their housing mission in a safe and profitable manner. They are not backed by the full faith and credit of the United States. This being the case, we do not believe that micromanagement of the FNMA and FHLMC by HUD, a *government* department, is appropriate.

We are also quite concerned that ensuring the safety and soundness of the FNMA and FHLMC could take regulatory primacy over ensuring that the FNMA and FHLMC meet their statutory housing goals. C.A.R.'s concern seems especially valid in light of the fact that the responsibilities of the OSMEO Director would not be subject to review by the HUD Secretary. Thus, the Director of the OSMEO could establish arbitrary risk-based capital standards for nnovative FNMA and FHLMC activities which might nhibit the ability of the entities to fulfill their affordable housing mission. Under the draft bill, the HUD Secretary, however, would have no authority to countermand such onerous capital standards even if the requirements did, in the view of the HUD Secretary, unnecessarily harm a key component of the federal government's housing support system.

The FNMA and FHLMC <u>are</u> safe and sound. All indications are that they will continue to operate in a safe and sound manner, especially in view of the public limelight which is now shining so brightly on the FNMA and FHLMC. Given this strength, C.A.R. believes that the GSE legislation approved by Congress should provide for the primacy of the programmatic regulator over the safety and soundness regulator.

Capital

C.A.R. believes that any housing GSE legislation approved by the Congress should specify the minimum capital, core capital and critical capital standards applicable to the FNMA and FHLMC We believe strongly that Congress should retain the authority to determine proper capital requirements for the housing GSEs. This responsibility hould not be relinqu shed to the Executive Branch of the federal government. We believe the provisions of the subcommittee draft in this respect represent a definitive improvement over the Treasury's proposed bill which, relative to leverage and critical capital ratios, would have provided the GSE regulator with the authority to establish "such other percentage" of "on- and off-balance sheet" obligations as believed necessary to ensure the safety and soundness of the FNMA and FHLMC.

With one major exception, C.A.R. is generally pleased with the capital prov ions of the subcommittee's bill. Again, we believe, as the subcommittee has done, that t is imperat ve on the part of the Congress to specifically, n statute, provide for <u>all</u> capital measures that are to apply to the FNMA and FHLMC and to their activities Thus, we appreciate the work of the subcommittee in including n ts draft legislation specific stress-tests to measure the credit risk and interest rate risk of mortgages owned or guaranteed by the FNMA and FHLMC.

Under the credit risk stress-test, the FNMA and FHLMC would have to maintain positive capital during a simulated eight-year period during which default losses occurred on a national level at the rate they occurred in a "standard

region" of the nation during the greatest period of losses in that region. Under the interest rate risk stress-test, the FNMA and FHLMC would have to maintain positive capital during a simulated eight-year period during which rates ncreased or decreased by the lesser of 500 basis points or 50 percent of the average long bond rate in the year prior to the simulated eight-year test period.

Showing their strength, both the FNMA and FHLMC have indicated that they would maintain positive capital under the proposed credit risk and interest rate risk stress-tests. C.A.R. recommends that Congress preserve the specific stress-tests proposed in the subcommittee draft bill in the final housing GSE bill it sends to the President.

Since C.A.R. believes specific capital standards for the FNMA and FHLMC should be included in any housing GSE bill approved by the subcommittee, we are opposed to section 201(a)(3) of the subcommittee draft which would give the OSMEO Director unilateral discretion to increase (or decrease) regulatory capital held for management and operations risk. Evidently, some HUD officials have already stated that, rather than the 20 percent standard proposed in the subcommittee draft, the capital standard for management and operations risk should be 50 percent or 75 percent of the FNMA's or FHLMC's regulatory capital requirements. We are concerned about the possibi ity that the OSMEO Director would increase required management and operations capital deterring the FNMA and FHLMC from taking the risks that are fundamental in devising products to assist housing, especially types of housing with significant management and operations risks, such as multifamily housing.

Along these same lines, C.A.R. is also opposed to section 201(a)(4) of the subcommittee draft which would permit the OSMEO Director to establish "appropriate" regulatory capital requirements for new GSE activities for which the FNMA or FHLMC has obtained the approval of the HUD Secretary. Going back to our belief that programmatic regulation of the FNMA and FHLMC should take primacy over safety and soundness regulation, this provision would give the OSMEO Director *de facto* authority to prohibit new FNMA/FHLMC programs.

It is not difficult to envision situations in which the HUD Secretary would approve a new activity as desirable from a housing point of view, but which the OSMEO Director views as too risky from a safety and soundness vantage point. In such occurrences, the OSMEO Director could simply establish such high capital requirements for the new activity that participation in the activity would not be cost-effective. Thus, while the HUD Secretary might have viewed the proposed new activity as beneficial and necessary, the OSMEO Director could overrule the determination of the HUD Secretary.

Again, C.A.R. believes programmatic act vities should be the chief concern with respect to regulation of the FNMA and FHLMC, and in no event do we believe Congress should transfer to the Executive Branch the authority to set such high capital requirements for new activities that it would all but preclude the FNMA or FNMA from participating in such activities.

In general, C.A.R. believes the specific capital standards proposed in the subcommittee draft bill are commensurate with the relatively low degree of risk associated with investments in residential mortgages. We are also pleased that the specific capital levels proposed in the subcommittee's draft bill are no more onerous that those proposed in the Treasury's legislation.

The specific capital standards proposed in the subcommittee's draft do not appear to be overly burdensome from the perspective of the present capital condition of the FNMA and FHLMC. Indeed, both housing GSEs have said that they would currently, or could soon, meet the capital requirements proposed in the draft bi C.A.R. commends the subcommittee for devising specific capita requirements which will protect taxpayers while not prohibiting the FNMA and FHLMC from fulfi ing the mission for which they were created.

Affordable Housing Program

C.A.R. is appreciative and supportive of the goals of the Affordable Housing Program (AHP) proposed in the subcommittee draft, especially those goals pertaining to increased ownership housing opportunities for low-income Americans. We are concerned, however, with the mechanism proposed to fund the Affordable Housing Program. In particular, we are concerned that this effort to aid affordable housing programs will end up doing more harm than good by mpacting the FNMA's and FHLMC's ability to raise cap tal The draft legislation would require the FNMA and FHLMC to make contribut ons equal to 20 percent of the prior year's dividend payments to ass st states and localities in the acquisition, development and rehabilitation of rental and ownership housing for very low- and low-income households.

Through a loss of capital leverage and programmatic efficiencies, the proportion-of-dividend requirement will make less money available to low- and moderate-income hous ng than if the FNMA's and FHLMC s used these funds to capital ze existing programs providing financing for such housing. Both the FNMA and FHLMC have established programs and new innovative services to aid low- and moderate-income housing efforts which are helping to address the needs of these groups.

C.A.R. also has serious concerns with the provision of the AHP authorizing the HUD Secretary to monitor FNMA and FHLMC pricing practices to ensure that the cost of the AHP is not passed on the investors. Section 313(c)(2) of the draft bill states that the HUD Secretary shall review the fees and charges imposed by the corporation...to ensure" that "fees or charges for the services of the corporation" are not increased.

This language raises the potentiality of the HUD Secretary being involved in the hundreds of fee and price decisions made by the FNMA and FHLMC each day. Given a need to adjust prices for market, competitive and non-related purposes, this requirement could truly bring the business of the FNMA and FHLMC to a complete halt. Micromanagement again becomes an issue.

CONCLUSION

In closing, C.A.R. wishes to emphasize that all studies done of the FNMA and FHLMC show that the housing GSEs pose little risk, if any risk at all, to the nation's taxpayers. As noted above, the preamble to the subcommittee's draft legislation recognizes the minimal financial risk posed by the FNMA and FHLMC to federal taxpayers. There is simply no comparison between the multi-billion dollar bailout of the S&L industry and the safety and stability of the federal housing GSEs. Consequently, there is no need to overregulate the FNMA and FHLMC or to place a non-existent safety and soundness threat over programmatic regulation.

The California Association of REALTORS® appreciates the opportunity to comment on the important legislative issues before the Housing and Community Development Subcommittee. If you have any questions concerning our GSE testimony or if C.A.R. can provide the subcommittee with any further information, please do not hesitate to contact Leslie Appleton-Young, Vice-President of Research and Economics, at (213) 739-8325. Thank you.

PREPARED STATEMENT OF ELLEN SCHLOEMER, FIRST VICE PRESIDENT, CORPORATE STRATEGY AND PROGRAM DEVELOPMENT AT GE CAPITAL MORTGAGE CORPORATION

Mr. Chairman, my name is Ellen Schloemer and I am First Vice President of Corporate Strategy and Program Development at GE Capital Mortgage Corporation ("GE Capital Mortgage") of Raleigh, North Carolina. I am pleased to submit this testimony on H.R. 2900, legislation regarding the financial soundness of government-sponsored housing enterprises. This statement will focus specifically on efforts to provide housing for the "affordable" sector of the homeownership market, particularly those young families and lower-income homebuyers who need low-downpayment mortgages in order to qualify for a modest, reasonably-priced home. These are families who would generally be priced out of the market without the availability of low-downpayment loans. It is important to recognize that the basic 95 and 90 loan-to-value (5% and 10% downpayment) loans are the backbone of an affordable housing program in the conventional market. Special initatives further expand homeownership opportunities to larger segments of the lower-income population.

Efforts to promote homeownership for these families have been developed by GE Capital Mortgage in partnership with Fannie Mae, Freddie Mac, community groups, state governments, labor unions, and, of course, lenders. As Jim Johnson, Chairman and CEO of Fannie Mae said earlier this year of his own company, "We are a financial partner, not a sole provider of housing. We work with others -- lenders; developers; community groups; and federal, state and local governments. Without dedicated partners with a stake in the enterprise, we cannot succeed. We will go out of our way to find partners and develop new partnerships." GE Capital Mortgage shares Jim Johnson's vision as a guiding business principle.

Much has been said about the importance of Fannie Mae and Freddie Mac to the marketplace. Traditionally, the secondary market agencies were developed to improve liquidity for lenders and to serve the countercyclical function of enhancing mortgage credit demand and availability, and maintaining a flow of mortgage capital among regions of the country. Today, the secondary market has greatly expanded its role and operates as the key link between primary mortgage lending and the major capital markets. Both Fannie Mae and Freddie Mac have experienced phenomenal growth and financial success in the past decade.

In today's environment, it is essential for Fannie Mae and Freddie Mac to focus on promoting and expanding affordable homeownership programs for first-time younger homebuyers, low and moderate income homebuyers, and others who are being priced out of the market. Such programs function best when they utilize all elements of our evolving mortgage finance system. These programs include expanding the availability of 5% and 10% downpayment mortgages. They also involve using non-traditional underwriting criteria and homebuyer counseling and education in order to reach a broader homebuying public.

As an executive of a private corporation, I envision the primary role of Fannie Mae and Freddie Mac as builders of programs and partnerships that utilize the talent and resources that both entities have developed in recent years. I especially recognize their obligations to their shareholders as private, profit-making companies. But we must all acknowledge that their status as "government-sponsored enterprises" brings significant benefits to the companies. This means that it is appropriate for Congress to require a strong commitment from these companies to help achieve national housing goals.

When Congress determined that these companies should issue stock to the public, it fundamentally altered the nature of the companies. It is inappropriate to siphon off their dividends as though they were a government department.

Further, while the affordable housing grant program in HR 2900 is well-intentioned, it does not seem to me to "play to the strengths" of the two corporations. We are submitting this statement because we believe there is a better, more suitable way to achieve these goals. The housing grant program seems more like a federal or state governmental agency program, which is providing "seed" money or operational funding for joint public-private initiatives, as under the recently-enacted HOME program. For a private sector corporation, this kind of program seems more like a charitable contribution or reaching for the "checkbook." Given the resources, skills and contacts of Fannie Mae's Office of Low and Moderate Income Housing and Freddie Mac's Department of Affordable Housing Initiatives and their successful work with numerous lenders, community groups, and yes, mortgage insurance companies, it would seem that using those resources for greater encouragement of homeownership programs which have been developed and are being refined and improved would be a better strategy to achieve the goals we all support than a "grant" program.

On a personal level, I have championed the involvement of my fellow employees in "Habitat for Humanity." Together, we have built five homes in the Raleigh area, working side-by-side with the people who became the owner-occupants of these homes. This kind of "hands-on" experience, I believe, proves to be more significant to my colleagues who roll up their sleeves and work, than a collection of contributions to a housing organization by GE Capital Mortgage employees. As a group of housing professionals, I think we can and should do more than raise funds in this area -- as important as we all know those funds are. We can be most effective if we put <u>all</u> of our skills and resources to work.

Let me tell you about some of the programs developed by GE Capital Mortgage along with our partners in the secondary mortgage market, our friends in the community, effective state housing agencies, and enlightened lenders.

We began working with the agencies more than three years ago to develop the Community Home Buyer's Program. In April 1989, GE Capital, the National Training and Information Center and Fannie Mae initiated a five-city demonstration program to give low and moderate income families greater access to mortgages by reducing the income required to qualify and reducing the cash required to close. The Home Lending Program marked the first time that all the components necessary for success were put together in one package. GE Capital provides the mortgage insurance, which allows Fannie Mae to purchase the mortgages, and local community groups provide counseling to borrowers about rehabilitating homes or building homes and providing a vast array of other services.

The expansion of the Home Lending Program was announced in September 1989 with Fannie Mae and Freddie Mac. This program combines the more flexible qualification criteria of the previous program with a comprehensive buyer education component. With assistance from Housing Opportunities, Inc., a non-profit organization with 14 years' experience in training new home buyers, GE Capital developed a new course for prospective loan applicants, which is offered through the participating lenders. And we are still working to make the program available to more potential home owners by making the courses more concise and by offering a home study guide for families that don't have access to classroom training in their areas. To date, over 33,000 potential homebuyers have gone through the training sessions.

We also introduced the Community Home Improvement Mortgage with Fannie Mae, which offers low and moderate-income households 5% down financing in one mortgage loan for the purchase and improvement of a home in need of modest repairs -- up to 30% of the home's after-repair value.

Fannie Mae and Freddie Mac are still working to allow families to get into homes they can afford to stay in. To this end, Fannie Mae recently introduced a 3/2 Program that permits buyers to meet the 5% down payment by using 3% from their own funds and 2% from a gift from a family member, grant, or unsecured loan from a non-profit group or public agency. GE Capital is proud to be a partner in this program.

And we worked with Freddie Mac to announce a borrower assistance program in conjunction with the AFL /CIO that will help union members and their families get into homes with smaller down payments.

In January, GE Capital and Fannie Mae announced the STABLE Home Mortgage, which combines fixed and adjustable rate mortgages in one note -- one mortgage with one monthly payment. One portion is set up at a fixed interest rate and the remainder is at an adjustable rate tied to the one-year Treasury Index. The program offers lower start rates than fixed rate loans and more stable rates throughout the life of the loan than traditional adjustable rate mortgages.

GE Capital was the first to announce a risk-sharing agreement with a state housing finance agency. These transactions reduce the cash required at closing for low- and moderate-income home buyers by providing mortgage insurance with greater underwriting flexibility and at lower cost. This is made possible by dividing the default risk into three tiers and allocating the risk for each tier between GE Capital and strong state agencies, GE Capital taking the first tier and third tier, which represents the vast majority of the risk. Since the program was introduced in December 1988, GE Capital has committed to insure almost $600 million in home mortgages for families in New Hampshire, Massachusetts, Pennsylvania and Rhode Island.

And these programs have tangible results by leveraging the strengths of the secondary market, lenders, community groups and mortgage insurers. And, at least based on GE Capital's experience, we can do it profitably. So these programs can perpetuate themselves. They won't have to stop if there are no extra funds for a dividend or a give-away program.

CONCLUSION

Let me assure you that each of these products may not be as "profitable" as other activities of these companies, and may not meet someone's objective yardstick of "average profitability." At the same time, we believe and have shown that financially sound investments can and are being made in these areas every day. And prudent underwriting can be done even when lenders accept "non-traditional" measures of creditworthiness. In fact, we have found in general that buyers who purchase reasonably-priced homes are good business risks who will make necessary financial sacrifices to own and remain in their homes. We have also seen the value of professional buyer education and training programs.

I believe that there is a simple "bottom line" which applies to these important enterprises. Their status as "government-sponsored enterprise" bring tremendous benefits to Fannie Mae and Freddie Mac, as you are well aware. It is most appropriate to seek a strong commitment in return from these entities to important "public missions." Among those missions -- and the one I regard as most important -- is active promotion and demonstrated results in programs to assist low and moderate income homebuyers, first-time buyers, and all those who seek to purchase modest, reasonably-priced homes with low downpayments.

It is essential that Congress clarify that the agencies' mission is to develop and promote homeownership affordability for first-time and lower-income buyers, with its focus on the availability of low-downpayment loans on an equitable basis as to access and pricing of such loans.

As I have emphasized, the best way to make that happen is to encourage development of programs -- and partnerships -- which involve the broadest possible elements of the mortgage finance system. We at GE Capital Mortgage stand ready to continue to work to achieve our common goals. I would respectfully request that this statement be made a part of the hearing record.

PREPARED STATEMENT OF NANCY SPADY, FIRST VICE PRESIDENT, EQUITY RESEARCH DEPARTMENT, LEHMAN BROTHERS

My name is Nancy Spady and I am a First Vice President of Lehman Brothers in the equity research department analyzing the GSEs and the thrift industry for investors. I would like to address my comments to several provisions of HR 2900 regarding regulation of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.

I strongly agree with the purpose of this legislation to ensure that Fannie Mae and Freddie Mac do not at some future date become a liability of the Federal government. My own analysis concurs with the many studies done in the past two years that concluded that these companies are well-run and pose no near-term risk to taxpayers. The proposed legislation appropriately provides for updated capital rules that recognize the business risks Fannie Mae and Freddie Mac take and creates a new regulator with clear responsibility to monitor the condition of the companies and intervene if their financial health deteriorates.

However, the proposed legislation goes far beyond the original goals of setting minimum standards for an equity cushion to protect agains difficult imes and monitoring Fannie Mae and Freddie Mac to ensure that problems do not arise unnoticed in the future. In my view, HR 2900 threatens to nterfere with two of the great success stories of the marriage of public policy with private enterprise. My concerns fall into two general categories. First, even if the two companies meet or exceed all the capital rules and stress tests set forth, the legislation appears to subject them to potentially significant interference in day-to-day operating decisions. Second, the proposed legislation would thrust upon the companies a new role in subsidizing low-income housing directly, despite their already extensive voluntary efforts that use their unique talents in bringing private capital and creative financing solutions to bear on this difficult problem.

Fannie Mae and Freddie Mac serve an important general public policy role by making the market for home mortgage funds more efficient, which both reduces the cost of these funds to homeowners and ensures availability of funds, even during difficult economic times. Their impact in both of these areas has been well documented in recent studies. However, provisions in the proposed legislation appear to open the possibility of disrupting this vast marketplace. Some of these provisions could limit the flexibility that has made Fannie Mae and Freddie Mac so successful both in meeting public policy goals and providing the financial stability and competitive returns that have attracted new sources of capital into the mortgage finance business even as the traditional sources disappeared in the 1980s.

While the proposed capital standards adequately address the credit and interest rate risks Fannie Mae and Freddie Mac face, in my view the broad discretion left to the Director of the new regulatory office undermines the rules set out and may have unintended effects on the mortgage finance market because of the uncertainty creates for managements of the two companies This seems especially so in the area of creating an additional capita cushion for management and operations risk, in which the proposed legislation sets a standard and then allows the Director to make it higher if he or she chooses. The Director's ability to reclassify a GSE at a lower enforcement level than its capital would indicate seems likely to add to this uncertainty.

Housing Subcommittee
Consideration of HR 2900
Nancy G Spady

The result is that these discretionary powers may affect pricing decisions and choices about capital structure by the two companies because of the uncertainty they create. Due to the pervasive presence of Fannie Mae and Freddie Mac in the mortgage market, these decisions could u imately have an unintended negative impact on the cost of mortgage financing across the country. Unlike the commercial bank or thr ft capital rules which employ relatively crude measures of risk the proposed capital standards for Fannie Mac and Freddie Mac directly assess the r abi ty to withstand shocks, whether from credi or interest rate risk by using stress tests This along with the regulator's ability to closely monitor them because there are only two companies in the industry, should allow the standard to capture their condition with greater accuracy This should limit the need for additional safety measures to more modest amounts and should limit the need for discretion by the Director.

One of the greatest reasons for the success of Fannie Mae and Freddie Mac, I believe, has been their stockholder-owned structure, including the incentives available in a private corporation. Congress set out a framework to direct the enterprise to help fund moderate-priced housing in the U.S. and has generally allowed the companies to function as the market dictated. believe some of the powers granted to regulators under the proposed legislation would interfere with this model. For example, new programs appear to need the approval of several government officials. This could limit Fannie Mae and Freddie Mac's responsiveness to new developments in both the types of mortgages offered in the primary market and the securities desired in the secondary market. That limitation could stifle innovation that has generally helped reduce the cost of mortgage financing in the last decade.

The limits on executive compensation also seem an impediment to the long-term functioning of these companies. Fannie Mae and Freddie Mac need to attract the most competent, qualified people possible to deal with the complex operations and financial decisions that accompany their crucial role at the center of the mortgage market. These individuals must be compensated at levels competitive with their alternative opportunities, whether that is on Wall Street, in the housing industry or elsewhere. The flexibility to reward people for performance is cri ical to attracting the talent necessary to run these companies, through good and bad times. The ability to use incentive compensation in the form of stock or options will also align management's interests with the long-term goals of the company, including its safe and sound operation, since shareholders must suffer first if Fannie Mae or Freddie Mac runs aground financially. Under the highly successful model set up by Congress, poor decisions in choosing or compensating management of one of the two companies can be judged by the board of directors and, ultimately, by the stock market, since both firms are subject to intense scrutiny and are closely compared with one another. In addition, the board of directors of each company, in keeping with its public charter, includes Presidential appointees whose role includes just such oversight. Thus, the restrictions on compensation seem unnecessary and potentially harmful.

Finally, the provision to require Fannie Mae and Freddie Mac to allocate a portion of their earnings to subsidize affordable housing directly seems to deviate from their special talents and I believe the enforcement provisions

attached to this tax-like measure could prove disruptive to the mortgage market. The two companies have shown themselves especially skilled at employing creative combinations of private and public sector resources to increase the availability of affordable housing in the U.S. Both companies have also made vast voluntary commitments to fund affordable housing apart from any requirement they must fulfill. The $10 billion Fannie Mae program and the $3 billion Freddie Mac program already make the two companies a primary source of funding for this public policy goal. However, the programs they have developed build on their unique talents, rather than using their resources merely as a pool of funds to tap with a special tax-like provision such as the one proposed. Given the typical funding structure of real estate projects, if Fannie Mae and Freddie Mac were to contribute $80 million of funds for affordable housing (the approximate amount that would be required for 1992), it would support perhaps $800 million of new development, far less than the voluntary commitments they have already made.

In addition, in order to enforce the provision that the companies not raise prices to pay for this levy, the companies' pricing decisions, which must change with constantly changing market conditions, would be subject to scrutiny and possibly alteration by regulators. Even the possibility of this event could disrupt the functioning of the entire mortgage market, as participants become unsure of whether any price is final until it is examined by the regulator. Again, this could disrupt the successful model in which Congress created a framework and a set of goals and then allowed the market to function smoothly. I believe using the companies' resources to fund this public policy goal will conflict with their larger mission that has reduced funding costs for millions of homeowners and made mortgage money available at all times even in the most economically distressed regions of the country.

Thank you for allowing me to comment on this proposed legislation. Assuming my concerns about these specific provisions are addressed, I think it will go far toward the important goal of ensuring the safety and soundness of these two vast enterprises so that they can continue to serve the mortgage market in the future.

July 17, 1991

TESTIMONY BEFORE THE SUBCOMMITTEE
ON HOUSING AND COMMUNITY DEVELOPMENT

Presented by
KATHRYN WYLDE, PRESIDENT, NEW YORK CITY HOUSING PARTNERSHIP

This testimony is offered on behalf of the New York City Housing Partnership, one of the nation's largest nonprofit producers of affordable housing.

Since 1983, the Housing Partnership has brought more than $1 billion in private financing for new housing to the City's low income communities, from Coney Island to the South Bronx, Central Harlem to Bedford Stuyvesant, the North Shore of Staten Island to Southeastern Queens. The Partnership has also assisted community-based initiatives working to rehabilitate multifamily housing, including LISC and Enterprise syndication of the federal Low Income Housing Tax Credit to corporate investors. We have established the City's first successful program to bring minority-owned contracting firms, matched up with minority-led nonprofit community groups, into the mainstream of the homebuilding industry.

As one of the nation's early Housing Partnerships, we have helped Fannie Mae pioneer their Low and Moderate Income programs. Some $300 million in permanent financing for Partnership first-time homebuyers -- with family incomes averaging about ninety percent of the current area median -- has come through Fannie Mae. To make this program work, Fannie's traditional underwriting and mortgage credit standards were adjusted to reflect the particular characteristics of the urban homeownership market. For example, Fannie has allowed enough credit for the rental income on two and three family, owner-occupied homes, so as to help households with limited resources qualify for

mortgages. Appraisal practices have recognized the strength of our housing market, allowing most of our homes to be sold with low downpayments and without the additional cost of mortgage insurance. We are currently working with Fannie on two multifamily projects to be financed on a lease-purchase model designed to further reduce unaffordable cash requirements for lower income households.

Fannie Mae is helping the Housing Partnership mount initiatives aimed at enhancing affordability and leveraging limited government housing subsidies with favorably priced investments by local banks, pension funds and international banking institutions. We recently established the GRAND program (Global Reinvestment in Affordable Neighborhood Development), through which foreign and international wholesale banks are investing in Partnership housing at concessionary rates. Through Fannie Mae mortgage backed securities, we have satisfied foreign banks and pension funds that they can invest in affordable housing and still be fully guaranteed against loss. Private placement of these securities is a mechanism for securing better terms and pricing than the conventional secondary market.

What our experience in New York City illustrates is that the rhetoric of public-private partnerships, particularly as it relates to federal-local joint ventures in affordable housing, is finally achieving some reality, as the secondary market institutions apply their enormous financial and professional resources to neighborhood housing needs. The purpose of my testimony is to urge Congress to use the opportunity of the GSE legislation to reinforce and support the emerging voluntary partnership between Fannie Mae, Freddie Mac and the nonprofit and community-based sectors of the nation's housing industry.

As traditional sources of public and private funding for housing have dried up, Fannie Mae, in particular, has become the financial lifeline for affordable housing. Some provisions of the draft GSE bill under consideration by this subcommittee could interrupt and unnecessarily limit the volume and scope of financing opportunities available to low and moderate income housing through the secondary market. Specifically, the draft bill allows for tightening of capital requirements and increased regulator intervention, while effectively limiting the resources committed to low and moderate income housing to an annual setaside. The result of this legislation could be to unnecessarily constrain Fannie and Freddie in their role as the primary

source of capital and credit for affordable housing.

What we do need -- particularly in the face of pressures to reduce the risk and limit contingent liabilities associated with GSE's -- is a Congressional mandate that authorizes Fannie and Freddie to create an alternative processing and underwriting track for affordable housing -- one that removes or reduces conventional restrictions on investment and securitizing activity, particularly for publically assisted multifamily housing.

There is no reason why GSE legislation or discussion should mirror the adversarial history associated with FIRREA and the Community Reinvestment Act. Fannie Mae has been a cooperative and even enthusiastic partner in structuring financial packages with nonprofits and local governments for hundreds of low and moderate income housing initiatives. Over the past ten years, this relationship has been substantially more productive and efficient than most groups have enjoyed with banking institutions or HUD.

While the Affordable Housing Fund created under FIRREA has been a welcome source of support for many projects, this level of subsidy is token in comparison to the housing capital and subsidy needs of the nation. In New York, it takes a grant of $75,000 to $125,000 to finance a single new or substantially rehabilitated unit of housing for a low income family. If New York were to get 10 per cent of the entire national allocation of Fannie Mae's proposed dividend setaside for 1991, this would support construction of about 30 units of low income housing. We are obviously concerned that the limited fund proposed for affordable housing in the GSE legislation will redirect attention away from a larger and more comprehensive role for Fannie and Freddie in affordable housing finance. This could be like trading in access to a credit line at JP Morgan for a piggy bank.

Right now there are opportunities for the secondary market institutions to play an expanded role -- especially in multifamily housing -- that will only happen with a Congressional nudge. Fannie and Freddie should be encouraged to establish a specially capitalized channel that applies more flexible standards to underwriting unconventional loans (which basically encompasses all our public-private, affordable and low income housing), securitizing or funding bridge loans, warehousing lines, letters of credit and construction financing.

There are also government subsidies that are underutilized because of constraints or obstacles in the flow of private and public funding that the secondary market can help to unblock. One example of an underutilized resource is the so-called low floater, tax exempt bond financing arrangement. Currently, multifamily mortgages financed through this mechanism are paying a market interest rate of 3%, largely due to the fact that there is a real shortage of tax exempt investment opportunities for mutual funds and others. It would cost about $2.5 million a year to match this level of subsidy for 500 units of low income housing. Unfortunately, this financing is difficult to access because the only sources of credit enhancement have been a few large Japanese Banks. The national secondary market is only beginning to apply its skills and credit standing to support bond issues and securitization of new pools of capital that can be priced more affordably in the marketplace -- without additional subsidy.

To achieve a meaningful volume of affordable housing activity, creative and dynamic application of all the resources of the secondary market institutions -- in partnership with HUD, local government, and nonprofits -- is essential. Underutilized FHA insurance authorizations and inefficient application of federal subsidy programs should be linked with and enhanced by the financial and professional resources of the secondary market institutions. This is the direction that Congress must encourage if we are to move federal leadership in low and moderate income housing beyond the anecdotal and into a generic restructuring of our system of residential finance that encompasses low and moderate income housing in the mainline business of Fannie Mae and Freddie Mac.

O

ISBN 0-16-036997-5